No. 7119

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 24663

JAMES R. WATKINS AND LUCILE L. WATKINS,
Plaintiffs-Appellants

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee

On Appeal From the United States District Court for the District of Connecticut

BRIEF FOR PLAINTIFFS-APPELLANTS AND APPENDIX

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BRIEF FOR PLAINTIFFS-APPELLANTS

JURISDICTION

This appeal involves claims for refund of federal income taxes for the years 1949, 1950, 1951 and 1952. The judgment of the District Court was entered on March 12, 1957 and the plaintiffs filed a notice of appeal on April 10, 1957. The jurisdiction of this Court is invoked under the provisions of 28 U. S. C., Section 1291.

STATEMENT

The facts found by the District Court are:

1. On April 17, 1934 there was issued to the plaintiff, James R. Watkins, (hereinafter referred to as "plaintiff") U. S. Letters

Patent No. 1,955,107 covering a wood cleated corrugated shipping container.

2. Subsequently, additional Letters Patent were issued to him for improvements on the shipping container as follows:

October 9, 1934, Letters Patent No. 1,976,693
December 27, 1938, Letters Patent No. 2,141,497; and
May 13, 1939, Letters Patent No. 2,159,642

3. In March, 1937, plaintiff entered the employ of Dillman Industries, Inc. and at that time entered into an agreement with it whereby he granted to it a non-exclusive license to manufacture containers under the patents which, up to that time, had been issued to him.

4. The manufacture and sales of the shipping containers proved to be successful and early in 1940 negotiations went on between plaintiff and some of the officers and leading shareholders of Dillman Industries, Inc., acting both on behalf of the corporation and themselves, personally, relative to new agreements for the exploitation of the patents.

5. During said period a new corporation, Watkins Patents, Inc., was organized under the laws of the State of Illinois, in which plaintiff owned twenty per cent of the shares issued and outstanding and the remaining eighty per cent of said shares were owned by Dillman Industries, Inc. or officers or shareholders of Dillman Industries, Inc.

6. On April 17, 1940, certain agreements were entered into as follows:

(a) Between plaintiff and Watkins Patents, Inc.—Exhibit A;

(b) Between Watkins Patents, Inc. and Dillman Industries, Inc.—Exhibit B;

(c) Between Dillman Industries, Inc. and plaintiff—Exhibit C;

(d) Between plaintiff, Dillman Industries, Inc. and Watkins Patents, Inc.—Exhibit D;

(e) Between Watkins Patents, Inc. and plaintiff—Exhibit E.

We do not believe that the general summary of these five agreements made by the District Court in Paragraph 6 of its Findings of Fact is completely accurate. Three typewritten copies of each agreement will be filed with this brief.

QUESTIONS PRESENTED

Defendant's Answer admitted that the patents constituted capital assets, within the meaning of Section 117 of the Internal Revenue Code of 1939, as amended, and had been held for longer than the period of time required to qualify them as long term capital assets. Only the issue of liability was tried before the District Court, the parties having agreed that in the event judgment should be ordered for plaintiffs, they would attempt to stipulate the amount of such judgment. This admission and agreement left as the only issue to be decided by the District Court the question as to the legal effect of Exhibit A—whether that agreement constituted a sale of the patents so that the amounts received by plaintiff as royalties during the years 1949 and 1950 constituted long term capital gains under Section 117 (a) (4) of the Internal Revenue Code of 1939, as amended, which is the statute applicable to the years 1949 and 1950, and whether that agreement constituted a transfer of property consisting of all substantial rights to a patent under Section 117 (q) of the Internal Revenue Code of 1939, as amended, which is the statute applicable to the years 1951 and 1952, or whether the amounts received constituted ordinary income for all years.

STATUTES INVOLVED

Section 117 (a) (4) of the Internal Revenue Code of 1939, as amended, provides:

"Sec. 117. (a) Definitions.—As used in this chapter—

* * * *

(4) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;"

Section 117 (q) was added to Section 117 in 1956 by Act of June 29, 1956, c. 464, 70 Stat. 404, Public Law 629, 84th Congress, 2nd Sess. and provides:

"(q) TRANSFER OF PATENT RIGHTS—

(1) General Rule—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminus with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

(2) 'Holder' Defined.—For purposes of this subsection, the term 'holder' means—

(A) any individual whose efforts created such property, or

(B) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(i) the employer of such creator, nor

(ii) related to such creator (within the meaning of paragraph (3)).

(3) Exceptions.—This subsection shall not apply to any transfer described in paragraph (1)—

(A) by a nonresident alien individual, or

(B) between an individual and any related person.

For purposes of this paragraph, the term 'related person' means a person, other than a brother or sister (whether of the whole or half blood), with respect to whom a loss resulting from the transfer would be disallowed under section 24(b).

(4) Applicability.—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred."

SUMMARY OF POINTS

1. Exhibit A constituted a sale or transfer of all substantial rights to the patents within Section 117 (a) (4) and 117 (q) of the Internal Revenue Code of 1939.

2. Assuming that Watkins Patents, Inc. did not receive the rights to make, sell or use the invention but only the exclusive right to license others, the right to prosecute and defend infringement actions and the rights of plaintiff in outstanding licenses, Exhibit A constituted an assignment.

3. Provisions constituting conditions subsequent included for the protection of plaintiff's rights to payment and of the assignee's title do not change Exhibit A from an assignment to a license.

ARGUMENT

Exhibit A constituted a Sale or Transfer of All Substantial Rights to The Patents Within Section 117 (a) (4) and 117 (q) of The Internal Revenue Code of 1939.

Stated generally, the sole issue before this Court is whether the agreement between plaintiff and Watkins Patents, Inc., Exhibit A, effected a sale or assignment of the patents on the one hand or a license on the other. In concluding that this agreement "was only the grant of a license," the District Court said:

> ". . . Such a study makes it apparent that what was transferred by Watkins to Watkins Patents, Inc. was the power to license or, as the court described it in *Six Wheel Corporation* v. *Sterling Motor Truck Co.*, 50 F 2d 568 (Ninth Circ.) at 573, the 'license to license.'
>
> ". . . The power to license with the incidental protective right to conduct or participate in infringement actions, and the rights in outstanding licenses were the only incidents of ownership which any of the parties intended to have conveyed and were in fact the only interests conveyed by James R. Watkins to Watkins Patents, Inc. . . ." (App. pp. 22-23).

By Article II of Exhibit A plaintiff "does hereby transfer and grant" to Watkins Patents, Inc.:

> ". . . . the non-transferable exclusive license for the use of and sub-licensing under each and all of the above referred to patents, including each and every part or subdivision thereof, together with the improvements thereon or extensions thereof for the life of said patents and each of same, or any part or parts or subdivisions thereof. . . ."

The District Court rejected the testimony of plaintiff and Messrs. Weis and Dillman that they intended that complete ownership of the patents should be transferred to Watkins Patents, Inc. (App. pp. 6, 11-14) and also the uncontroverted testimony of

the distinguished attorney who drew up the agreements that "the idea was to sell the patents . . . to this new corporation, Watkins Patents, Inc., that is in 1940, and this was done" (App. p. 16) on the sole ground that "neither any such words ("complete ownership" or "ownership") nor their legal equivalents were used in the lengthy written agreements drafted by their counsel." (App. p. 24). It then held that testimony of the same witnesses that their intention was to have Watkins Patents, Inc. issue licenses limited the meaning of "use" in Article II of Exhibit A to "exploitation of the patents by issuing licenses." Such restriction results in the word "use" having no purpose in the granting clause, since that clause already expressly grants the right of "sub-licensing." The District Court's construction makes the clause read that plaintiff does hereby transfer and grant "the non-transferable exclusive license for the issuing of licenses and sub-licensing under each and all of the above referred to patents . . . ." and so the Court concludes that the rights to make, use and sell the product were not transferred to Watkins Patents, Inc.

With this brief explanation of the District Court's initial position, an examination of Exhibit A is in order. It purports to transfer and grant an "exclusive license;" the use of that term does not prevent the transfer from constituting an assignment.

> "Whether a transfer of a particular right or interest under a patent is an assignment or a license does not depend upon the name by which it calls itself, but upon the legal effect of its provisions. . . ." *Waterman* v. *MacKenzie*, 138 U. S. 252, 256.

Some of the many decisions holding the transfer to be an assignment notwithstanding use of the term "license" by the parties are:

Watson v. *United States*, (CA10) 222 F 2d 689, 691;
Rollman v. *Commissioner*, (CA4) 57-1 USTC 9677;
United States v. *Carruthers*, (CA9) 219 F 2d 21;
Reed v. *Commissioner*, 26 T. C. 622.

In fact, in *Pike* v. *United States*, (D. C. Conn.) 101 F. Supp 100, the agreement expressly provided that: "This agreement shal be construed as a license of the aforesaid patents and not as an assignment thereof from Pike to Westvaco," but Judge Hincks held, on the basis of other provisions, that the agreement constituted an assignment of the patents.

Obviously, the transfer of an "exclusive license" is even more indicative of an assignment than is the transfer of a "license." In *Goldsmith* v. *Commissioner*, (CA2) 143 F 2d 466, Judges Learned Hand and Swan held that the grant of an "exclusive license" under a copyright was a sale. At page 468 of that decision, Judge Hand said:

> ". . . It does not unduly strain the meaning of 'sale' to make it include an exclusive license; in the case at bar the parties themselves used the words 'grant and assign' . . ."

In the instant case, Exhibit A uses the term "transfer and grant" and in *Niagara Hudson Power Corporation* v. *Hocy* (CA2) 117 F 2d 414, 416; cert. denied, 313 U. S. 571, this Court said:

> ". . . But in legal jargon a change of ownership, terminating rights and other relations in one entity and creating them in another, is the essence of 'transfer' . . ."

The "transfer" of an "exclusive license" would seem to be much closer to an assignment than to a license.

The District Court admitted that "under certain circumstances and in certain contexts" the transfer and grant of "the non-transferable exclusive license for the use of an sub-licensing under each and all . . . the patents" could be construed as an assignment or sale, although it referred to this language of Exhibit A, as "such an imprecise expression of assignment or sale." (App. p. 21). With the latter we differ strongly. The United States Supreme Court has frequently employed the term "use the

patent" as meaning "make, use and sell under the patent." For instance, in *Hartford-Empire Co.* v. *U. S.*, 323 U. S. 386, 417, the Court considers a paragraph in the decree of the lower court:

> "Under paragraph 24(b) a defendant hereafter acquiring a patent cannot set the price for its use by others, elect to use it himself and refuse to license it, or to retain it and neither use nor license it. These are options patent owners have always enjoyed."

And at page 432, the Court says:

> "A patent owner is not in the position of a quasi-trustee for the public or under any obligation to see that the public acquire the free right to use the invention. He has no obligation either to use it or to grant its use to others. . . ."

In *Continental Paper Bag Co.* v. *Eastern Paper Bag Co.*, 210 U. S. 405, at page 425, there appear two statements as to what an inventor receives from a patent. The quotation is:

> ". . . It shows that whenever this court has had occasion to speak it has decided that an inventor receives from a patent the right to exclude others from its use for the time prescribed in the statute. . . .
>
> "And, in *Bloomer* v. *McQuewan*, 14 How. 539, 549, Chief Justice Taney said: 'The franchise which the patent grants consists altogether in the right to exclude everyone from making, using or vending the thing patented, without the permission of the patentee. That is all he obtains by the patent'."

It seems clear that "the right to exclude others from its use" in the first sentence is synonymous with "the right to exclude everyone from making, using or vending the thing patented" in the second. This point is made in *Daily* v. *Universal Oil Products Co.*, (D. C. Ill.) 76 F. Supp. 349, at page 356:

> "It seems clear that the transfer of the exclusive use and control of the patent No. 646,639 and the process covered thereby, to Sunset Oil Refining Company under the agree-

ment of May 5, 1900, constituted an assignment of the title of the patent. . . .

"The grant of the exclusive use and control of the process in patent No. 646,639 was not less than the right to make, to use and to vend the processs covered by the patent and the products created by the process. . . ."

We submit that it is well established by usage of the United States Supreme Court that a transfer of the exclusive use of a patent is a precise expression of an assignment of the right to make, use and sell under the patent. Innumerable instances of this usage of the term "use of the patent" by other authorities could be produced.

In several other tax cases in which the term "use the patent" or its equivalent was employed, the Courts held that an assignment was effected. In *Associated Patentees, Inc.* v. *Commissioner*, 4 T. C. 979 and in the connected case of *United States* v. *Borton*, (D. C. N. J.) 50-1 USTC 9276, four individuals entered into an agreement with a corporation which they formed and in which each had a twenty-five per cent interest, which provided that "in consideration of the use of numerous patents," the corporation agreed to pay "as royalties for the use of the patents and inventions turned over," twenty per cent of all royalties received by the corporation from licenses. Both the Tax Court and the District Court held that the agreement constituted a sale of the patents.

In *Reid* v. *Commissioner*, supra, petitioner gave a corporation the exclusive right "to utilize her design patents and/or process patents . . ." The Tax Court held, and the Commissioner has acquiesced in the decision, 1956-47 Int. Rev. Bull. 6, that a "complete assignment was intended and made, and that the exclusive right to 'use' petitioner's name and patents throughout the United States for the full period of their existence was transferred . . ."

In *Pike* v. *United States*, supra, plaintiff granted and conveyed "the exclusive right and license to practice and use the processes described and claimed in the aforesaid patents . . ." and the Court held that an assignment was effected.

Finally, in the recent case of *Gruber* v. *United States*, (D. C. Ore.) 57-2 USTC 9762, the agreement gave ". . . the sale and exclusive right and license to use" the patent and the Court held that it constituted an assignment.

We submit that there is absolutely no difference between these cases and the instant case insofar as the construction of the phrase "use of the patents" is concerned. Plaintiff as patentee originally had the exclusive right to use the patents as he saw fit; in his use of the patents he could manufacture, sell and use the container, the transfer by him of the exclusive right to use the patents was, in the words of the Court in *Daily* v. *Universal Oil Products Co.*, supra, "not less than the right to make, to use and to vend" the containers covered by the patents. Watkins Patents, Inc. received these rights by assignment; the fact that the parties did not intend to have the corporation manufacture should not change the legal effect of the transfer to it. The argument of the District Court is that to accomplish the exploitation of the patents, Watkins Patents, Inc. did not need the rights to make, use and sell but only the power to license; that since it did not need these powers, the parties did not intend it to have them and so it did not receive them. The case relied upon by the Court, *Six Wheel Corporation* v. *Sterling Motor Truck Co.*, supra, involved a corporation which was expressly prohibited by agreement from manufacturing, using and selling. In the instant case there is absolutely no prohibition upon Watkins Patents, Inc.; there is a great deal of difference between a prohibition against manufacture and an intention not to exercise the right to manufacture. The fact that it was not intended that Watkins Patents, Inc. manufacture and sell did not prohibit it from doing so; in fact, it was incorporated as an ordinary manufacturing corporation. (Tr. p. 83).

This conclusion of the District Court is completely contrary to the testimony of the parties to the negotiations—the plaintiff who acted in his own interest and Messrs. A. W. D. Weis and K. W. Dillman, who acted in the interests of themselves, Dillman Industries, Inc. and Watkins Patents, Inc. Mr. Weis testified that the plaintiff was selling and his interests were buying (App. p. 14), that their intentions were that, for the life of the patents and any improvements thereon, they would have ownership of them (App. p. 14). Mr. Dillman testified:

> "But we were not willing to go ahead with this thing unless we could have the complete ownership of it, because we realized we were going to have to spend an awful lot of money. When we finally did go ahead, we spent over $50,000 on one experimental machine." (App. p. 6).

In answer to a question by the Court, Mr. Dillman said:

> "Q. You say that you wanted something more than a license. You wanted to own the patent is that it? A. That is right. If we were going to go ahead and put more money in it and expand this operation, yes, sir." (Ap. p. 6).

Later he testified:

> ". . . And Mr. Weiss stated that he was willing to go along with it and to have Dillman Industries provide the financing for it, but only so long—we told Mr. Watkins very definitely at that time—that only so long as we had complete ownership of the patents." (App. p. 6).

The District Court relies considerably on the following questioning which happened on cross-examination:

> "Q. That, is, the Watkins Patents, Inc sole job was to handle the sub-licensing? A. It was to handle the licensing of licenses.
>
> "Mr. WEIR. I object to that, your Honor. I don't recall any testimony to that effect.

"The COURT. Well, obviously it would include the interest in the patents, the holding of the interest in the patents. Is that the objection.

"Mr. WEIR. Well, that is the objection. I think he used the word 'sole.'

"The COURT. He said solely. By that you didn't mean, I take it, to exclude the patents because they couldn't very well grant licenses if they didn't have any interest in the patents?

"Mr. GITELMAN. No. What I am driving at is that Watkins Patents, Inc. was not created to manufacture boxes.

"A. No, we didn't." (App. pp. 9-10).

This episode is the only evidence upon which the Court relied in holding that the "sole" job of Watkins Patents, Inc. was to issue licenses although the District Court itself pointed out that the corporation couldn't grant licenses unless it had an "interest" in the patents. A licensee has no proprietary interest in patents. Furthermore, this testimony does not support a conclusion that because the parties did not intend that Watkins Patents, Inc. manufacture under the patents, they did not intend to transfer ownership of the patents to that corporation. What the District Court by hindsight thought that Messrs. Weis and Dillman needed to accomplish their purpose is not important, what they themselves thought they needed at the time is very important. They thought they needed ownership of the patents to protect both the money they were putting into the corporation and the cost of the machinery which they were developing for making the container. That was their uncontroverted testimony. The conclusion of the District Court that all they needed was a license and therefore that is all they got is not supported by any evidence. What they thought they needed was "complete ownership" and that is what they thought they received. Mr. Dillman quotes Mr. Weis as saying to plaintiff on the occasion of subsequent discussions:

". . . . 'We own this patent. You don't have a damn thing to do with it now'." (App. p. 9).

Defendant did not even bother to cross-examine Mr. Lancaster That distinguished member of the Illinois Bar for over fifty years testified on deposition that ". . . in 1940 the idea was to sell the patents. I think there were four if I remember rightly, to this new corporation, Watkins Patents, Inc., that is in 1940 and this was done. . . ."

Other provisions of Exhibit A clearly indicate that an assignment was intended and effected. Article VII requires that Watkins Patents, Inc. establish a fund of Ten Thousand Dollars "for the purpose of defraying any expense incurred by it in litigation for protection of the aforesaid patents." Article VIII provides that if Watkins Patents, Inc. exhausts said fund and refuses to "continue to prosecute or defend further said patent litigation," plaintiff could then take over and if the "conclusion of said litigation sustains the issues in favor of Second Party" (Watkins Patents, Inc.), plaintiff would be reimbursed for his expenses out of the first royalties thereafter collected. These provisions would seem to compel a conclusion that an assignment and not a license was intended since a licensee has no right to sue infringers. *E. W. Bliss Co. v. United States*, 253 U. S. 187, 192; *Littlefield v. Perry*, 21 Wall. 205, 223. In *Ellis, Patent Assignments*, Sec. 55, the author states:

> ". . . The broad fundamental practical difference between an assignment and a license is that the former gives the transferee the right to sue for infringement and the latter gives the transferee immunity from suit for infringement. The first gives positive rights, the second negative rights."

Once again we turn to the Pike decision, supra. At page 101, Judge Hincks states:

> ". . . The agreement shows that intent to be that Westvaco for the life of the patent should not only have the exclusive right to practice the processes and to license others but, very significantly, the right to enforce the patents against infringers in its own name, retaining as its own any recov-

> eries so obtained. Thus the operative intent was plainly to pass all the rights the plaintiff had. A transaction having such an intended effect was an assignment of the proprietary interest and hence in legal effect a sale. . . ."

The similar facts that Exhibit A gives Watkins Patents, Inc. the exclusive use of the patents with the right to license others, the right to prosecute and defend infringement suits in its own name and obviously contemplates that, after payment of expenses, recoveries shall be retained by it, are significant indications in this case that an assignment of the proprietary interest was intended and effected.

Also indicative of an assignment are the provision of Article II of Exhibit A expressly transferring to Watkins Patents, Inc. "all licensing agreements heretofore made under said patents" by plaintiff and the provision of Article XII requiring plaintiff to deliver to Watkins Patents, Inc. an additional assignment of these prior licenses in proper form for filing in the Patent Office. Thereafter the licenses outstanding were beyond question owned by Watkins Patents, Inc. but under the District Court decision it owned neither the patents nor the licenses thereafter issued by it. Obviously, the parties did not contemplate such a situation but intended that the provisions for assignment of the prior licenses should coincide with the assignment of the patents and place the complete ownership of all interests in Watkins Patents, Inc. As stated in *Hook* v. *Hook & Ackerman, Inc.* (CA3) 187 F 2d 52, 58:

> "The assignment to the corporation of the non-exclusive license previously granted to Sears, Roebuck and Co., further emphasizes the fact that there was an intent to pass full ownership to the corporation. . . ."

The surrender by Dillman Industries, Inc. of the license issued to it by plaintiff and the issuance of a new license (Exhibit B) from Watkins Patents, Inc. to it is still further indication of where the parties intended ownership to rest as is the issuance

by Watkins Patents, Inc. to plaintiff of a license (Exhibit E). The issuance of these two licenses by Watkins Patents, Inc. is a practical construction of Exhibit A by the parties and is very conclusive evidence that the parties contemplated that all proprietary rights should be transferred to Watkins Patents, Inc. by Exhibit A. Exhibit E is also clear evidence that plaintiff intended to give up all right to manufacture and sell since he felt that he needed a license from Watkins Patents, Inc. to do so. If Exhibit A transferred only the power to license then Exhibit E was entirely unnecessary and Exhibit B should have run from plaintiff to Dillman Industries, Inc. as did the prior license.

We respectfully submit that all of these provisions clearly indicate that a transfer of "complete ownership" of the patents was intended. As pointed out, supra, the District Court rejected testimony by the parties to the negotiations that they so intended on the sole ground that "neither any such words nor their legal equivalents were used in the lengthy written agreements . . . ." Obviously the words "ownership" and "complete ownership" do not appear in the agreements but the provisions hereinbefore discussed are the legal equivalents of those expressions. Obviously, too, we would not be in court if the agreements were more specific nor would the other cases have been before the courts on this point if the agreements were not subject to some construction.

II

Assuming That Watkins Patents, Inc. Did Not Receive the Rights to Make, Sell or Use the Invention But Only the Exclusive Right to License Others, the Right to Prosecute and Defend Infringement Actions and the Rights of Plaintiff in Outstanding Licenses, Exhibit A Constituted an Assignment.

The practical effect of the District Court's decision that the transfer of the exclusive right to use a patent and to issue licenses

thereunder to a corporation formed for the purpose of engaging in the business of issuing licenses cannot be an assignment but is only a license to license is that a holding company cannot be the owner of patents. If correct, the decision is of far reaching importance in view of the thousands of such companies which must now exist. The Hartford-Empire Company was an outstanding example—it was purely a patent holding company engaged in licensing others. In *Hartford-Empire Co.* v. *United States*, 323 U. S. 386, it was sued as the owner of patents. In *Associated Patentees, Inc.* v. *Commissioner, supra,* and *United States* v. *Borton, supra,* both the Tax Court and the District Court held that Associated Patentees, Inc. was the owner of patents by assignment although it engaged solely in the business of licensing others. Similarly, in *Massey* v. *United States,* (CA7) 226 F 2d 724, the finding of facts discloses that the assignee was not a manufacturer.

The District Court's argument is that because the parties did not intend that Watkins Patents, Inc. manufacture, use and sell under the patent, plaintiff did not intend to transfer those rights to that corporation and the term "use of the patent" is not to be given a recognized and established meaning but is to be given the very restricted and unusual meaning of "issue licenses under the patent." This position fails to recognize that Watkins Patents, Inc. as owner of the patents was under no obligation to use them. *Hartford-Empire Co.* v. *United States, supra,* at page 432. Furthermore, this position of the District Court is predicated solely upon the decision in *Six-Wheel Corporation* v. *Sterling Motor Truck Co.*, supra. We have already pointed out the distinction between that case and this—in that case the transferee was prohibited by express agreement from manufacturing, using or selling the invention while in this case there is no prohibition or restriction of any kind; the fact that it may not have been intended that Watkins Patents, Inc. manufacture, use or sell the invention did not prohibit it in any way from obtaining that right. Further-

more, the initial intention that Watkins Patents, Inc. not manufacture, use or sell was based upon the idea that Dillman Industries, Inc. was doing that. In two years, however, the latter was out of business and the situation might well have changed so that the parties may then have caused Watkins Patents, Inc. to manufacture. The point is that the original intention did not mean that the parties did not intend that plaintiff transfer complete ownership to Watkins Patents, Inc. so that at some future time it might manufacture.

A further distinction between these two cases emphasizes the essential difference between license and assignment. In the Six-Wheel Corporation Case, the ultimate holding was that the transferee, being only a licensee could not sue an infringer. In this case, that power is expressly given to the transferee. Does this not clearly indicate that our transferee is an assignee?

However, the Six-Wheel Corporation Case is not only distinguishable, it is wrongly decided. In *Standard Oil Co.* v. *Markham*, (D. C., S. D., N. Y.) 64 F. Supp. 656, Judge Wyzanski points out the error and in the case on appeal, *Standard Oil Co.* v. *Clark*, (CA2) 163 F 2d 917; cert. denied, 333 U. S. 873, this Court supported his view at page 929. In his decision, at page 661, Judge Wyzanski states:

> ". . . In this opinion it will be sufficient to deal with the Custodian's main argument that the purported assignments of legal title were ineffective because under the limitations of its own corporate charter and of the Four-Party Agreement S. I. G. could not manufacture under the patents but could use them only to license others.
>
> "This argument of the Custodian is bottomed upon the rulings in *Crown Die & Tool Co.* v. *Nye Tool & Machine Works*, 261 U. S. 24, 36, 43 S. Ct. 254, 67 L. Ed. 516; *Universal Oil Products Co.* v. *Root Refining Co.*, D. C. D. Del., 16 F. Supp. 846, 852, affirmed, 3 Cir., 93 F 2d 186; and *Six-Wheel Corporation* v. *Sterling Motor Truck Co.*, 9

Cir., 50 F 2d 568. From those authorities the Custodian spells out the theory that where a person has not the right to make, use or vend the invention that person cannot be the holder of the legal title to the patent.

"The theory of the Custodian is not in accord with the patent law. Where the patentee assigns to another the exclusive right to make, use and vend the invention but that other by a collateral agreement disables himself from making or using, or vending the invention, or that other grants back to the assignor an exclusive license, there is none the less a valid assignment of title. . . .

"This familiar doctrine of patent law is in no way denied by the Crown Die and Tool case. . . .

"The Universal Oil Products case cited by the Custodian is in reality an authority against him. . . .

"The Six-Wheel Corporation case might perhaps be distinguished on the narrow ground that there the patentee purported to assign the legal title to another 'subject to the condition that said Company (i.e. the assignee) shall not itself manufacture, use or sell any device or devices embodying or containing said invention' (50 F 2d 573). But it is more candid to say that the decision of the Ninth Circuit Court of Appeals is so plainly at variance with the weight of authority that it should be discredited and not distinguished."

We submit that Watkins Patents, Inc. received a valid title to the patents under Exhibit A notwithstanding the parties did not intend it to manufacture, use or sell under those patents but merely to license others to do so.

III

Provisions Constituting Conditions Subsequent Included for the Protection of Plaintiff's Rights to Payment and of the Assignee's Title Do Not Change Exhibit A From An Assignment to A License.

The District Court took another slant—even if Exhibit A did constitute an assignment, too many "legal interests" found their way back to plaintiff. Two, three or four such interests would be all right but the line must be drawn somewhere and this is it. The Court makes no distinction between broad powers and limited powers—for instance in some of the decided cases the right to terminate is extremely broad while in the instant case it is limited to the failure of Watkins Patents, Inc. to borrow from Dillman Industries, Inc. "for the purpose of paying any expenditures incurred by it as needed for patent litigation . . ." We submit that counting legal interests which vary in scope and effect is not the realistic way to deal with liability for tax.

We do not believe that this Court is going to decide the issue in this case on the basis of the number of interests involved but we will point out that there is no way of knowing whether all of the so-called interests present in a particular case have been discussed by the Court in its opinion. In *Commissioner* v. *Celanese Corp*, (CAD of C) 140 F 2d 339, 342 the Court mentions "the various provisions to which we have referred, as well as the others referred to by the Commissioner." Obviously, if a Court regards a provision as unimportant to its decision it may not mention it. In *Pike* v *United States, supra,* the agreement contains the following conditions but they are not all mentioned in the opinion:

(1) Westvaco (assignee) must account and pay royalties;

(2) For five years, Pike (assignor) to act in a consulting capacity for Westvaco without further compensation;

(3) Pike to bear all expenses, costs and damages in infringement suits against Westvaco; if injunction issued Westvaco could cancel;

(4) If Westvaco fails to prosecute infringement action when requested, Pike could take such steps at his own expense as he deemed proper;

(5) Pike may cancel on any breach of any covenant or agreement contained in the agreement, default in payment of any royalty or in making of any report;

(6) Agreement not assignable by Westvaco for period of five years;

(7) Westvaco could cancel on one year's notice.

Let us examine in detail the so-called "legal interests." Obviously, the ownership of a minority interest in Watkins Patents, Inc. is not an interest in the patents. In *Graham* v. *Commissioner*, 26 T. C. No. 90, the assignors owned a majority of the stock in the assignee. The Court considered that fact in determining whether or not a bona fide sale had been made. While the stock ownership is important for that purpose, it does not represent any proprietary interest in the patents.

The provision for payment of royalties does not constitute an interest in the patents nor does it affect the title to the patents. After an assignment has been made, the right to be paid therefor, whether in cash or in instalments, is in no respect a proprietary interest in the patents. In *Watson* v. *United States*, *supra*, at page 691, the Court said:

> "The agreement contained a provision for payment of royalties. That provision merely fixed the compensation to be paid as consideration for the transfer. It did not reserve to Watson any control over the patent or its use. It did not limit or qualify the scope of the grant. . . ."

See also: *Rude* v. *Westcott*, 130 U. S. 152, 163;
Hopkinson v. *Commissioner*, (CA2) 126 F 2d 406.

We have already pointed out that Watkins Patents, Inc. has the right and duty to prosecute and defend infringement suits and the duty to pay the expense of such suits. Plaintiff's right in this respect is limited to continuing the prosecution or defense of such litigation if Watkins Patents, Inc. exhausts its funds and the amount borrowed from Dillman Industries up to $10,000 and then refuses to proceed further. If the litigation is terminated favorably for Watkins Patents, Inc., plaintiff's expenses are to be paid out of the first royalties thereafter collected. This very limited right in connection with infringement suits must be compared with the broader provisions in some of the other assignment agreements. In *Littlefield* v. *Perry*, *supra*, and *Pike* v. *United States*, *supra*, the assignor was required to bear all costs and expenses of litigation and all damages; in *Watson* v. *United States*, *supra*, both assignor and assignee were required to act jointly in resisting infringement; in *First National Bank of Princeton* v. *United States*, (D. C., N. J.) 136 F. Supp. 818, the assignor was required to defend infringement suits brought against the assignee and to save the assignee harmless from any damages recovered in such suits. In all of these cases the rights and duties were held not to affect the transfer of the proprietary interest; certainly, therefore, the much narrower right in the instant case can have no effect.

As already mentioned the power to terminate is limited to the failure of the assignee to borrow from Dillman Industries, Inc. for the purpose of defraying patent litigation expenses. Compare this limited power to those in some of the other agreements. In *Allen* v. *Werner*, (CA5) 190 F 2d 840, the assignor could terminate if the assignee violated the provisions of the agreement "in any way" and the assignee could cancel on 90 days notice; in *Pike* v. *United States*, supra, the assignor could terminate on breach of any covenant in the agreement or default in payment of royalties, if not corrected; and the assignee could cancel on one year's notice; in *Littlefield* v. *Perry*, supra, the agreements contained a provision for forfeiture in the case of nonpayment or neglect to sell the

patented articles to the extent of a reasonable demand therefor. At page 220 of the decision in the Littlefield Case, the Supreme Court said:

> "When the 'grant' was placed on record, Treadwell and Perry became the apparent owners of the entire patent and inventions throughout the specified territory. Neither the agreement to account and pay the royalty nor the clause of forfeiture contained in that instrument reduced them to the position of licensees. The agreement to account and pay formed part of the consideration of the assignment, and was in effect an agreement to pay at a future time a sum to be determined by the number of articles made and sold. For the non-payment or other non-performance a forfeiture might be enforced as for condition broken, but until it was enforced the title granted remained in the assignees."

See, also: *Boesch* v. *Graff*, 133 U. S. 697, 701.

Obviously, these provisions relative to patent infringement were conditions subsequent inserted for the protection of the assignee's title and the assignor's right to realize upon the patents. Normally, the provision for approval of licenses by the assignor is regarded as for the protection of the assignor. However, in the instant case, Mr. Weis explained that the purpose was also to benefit the assignee. The provision in Article VI of Exhibit A is simply: ". . . . the sub-licenses to be approved by said First Party. . . ." With respect to it, Mr. Weis testified on cross-examination:

> "Q. In your examination—direct examination—you indicated that Watkins had the say-so, by that do you mean that Watkins made it clear he wanted to have the power to object to such licenses as you might want to issue? A. No, he knew the people better than we did. He knew whether we should issue the license or not—we didn't want to have too many licenses in a territory—that would have a tendency to cause price cutting and friction with our licensees. We wanted licenses but we wanted to distribute them in a territory that

could consume them without cutting each others throats. We just let Mr. Watkins sort of figure that out." (App. p. 15).

In *Rollman* v. *Commissioner, supra*, the Court says:

". . . The authorities do not support the view that the grant of exclusive rights under a patent does not amount to a transfer of a capital asset if the assignee cannot grant a sub-license without the assignor's consent. Such a limitation does not interfere with the full use of the patent by the assignee and it serves to protect both parties to the assignment in case the purchase price is paid in instalments. . . ."

See also: *Platt* v. *Fire Extinguisher Mfg. Co.*, (CA3) 59 F. 897, 901.

The similar provision that the license was non-transferable was considered in *Watson* v. *United States*, supra, at page 691:

"The contract contained a further provision that the rights of the licensee thereunder should not be assigned without the consent of the licensor having been obtained in writing. That precautionary provision was intended to protect the rights of the parties under the contract, not to proscribe, limit, or nullify their intent and purpose to vest immediately in the transferee the right to manufacture, sell and use the carts throughout the life of the patent, as well as any extension or extensions thereof. . . ."

See also: *Allen* v. *Werner*, supra, 842;

First National Bank of Princeton v. *United States*, supra, 823;

Crook v. *United States*, (D. C. W. D. Penn.) 135 F. Supp. 242, 252.

Exhibit E is a license from Watkins Patents, Inc. to plaintiff. By its terms plaintiff could not use it so long as he was employed by Dillman Industries, Inc. under Exhibit C. If, however, he left that employ, which he could do after June 30, 1941, he could associate with others in manufacturing under this license; if this

association terminated, the former associates of plaintiff would be entitled to obtain a standard license from Watkins Patents, Inc. The District Court was much concerned with what the plaintiff might do under this provision although it knew that the plaintiff had never even used the license himself and had been in the employ of Watkins Patents, Inc. since Diliman Industries, Inc. went out of business in 1942. (Tr. p. 50). However, the broadest effect of the provision is to construe it as terminating the exclusive character of the right transferred to Watkins Patents, Inc. This provision is obviously a condition subsequent since it could by no means be effective until June 30, 1941, more than one year after the date of the agreements. The consideration of a similar provision in *Watson* v. *United States*, supra, at page 691, is relevant:

> "The agreement contained a provision relating to the termination of its exclusive character. The substance of the provision was that, in the event the corporation should after one year from the date of the agreement fail to make and sell 2,500 carts during any six-months period, the licensor should be free to license others to manufacture and sell carts. But that provision concerned itself exclusively with a condition subsequent. It did no more than provide that upon the occurence of a stated event the grantor was empowered to terminate the exclusive right and title theretofore conveyed. It did not detract from the effectiveness of the agreement as constituting an assignment of patent rights. . . ."

Of course, the granting of the license back to plaintiff, while very strongly evidential that the parties intended to vest complete title to the patents in Watkins Patents, Inc., had no effect upon the transfer of that title. See *Littlefield* v. *Perry*, *supra*, p. 220.

We submit that the presence of these conditions subsequent have no effect upon the transfer of title to Watkins Patents, Inc. so

long as the conditions were not broken. As stated in *Platt* v. *Fire Extinguisher Mfg. Co., supra,* at page 901:

> ". . . The title was conveyed to the complainant subject only to certain conditions, and the assignor had no more right to it than a stranger, so long as the conditions should remain unbroken. If the complainant should fail to keep his covenants, then the conditions would be broken. and the property would revert to Graham. Until this event happens the complainant has the right to protect his interests by suing infringers of the patent. . . ."

See also: *Littlefield* v. *Perry, supra,* 220;
Boesch v. *Graff, supra,* 701.

CONCLUSION

The decision of the District Court is erroneous and should be reversed.

Respectfully submitted,

CURTISS K. THOMPSON,
JOHN H. WEIR

August, 1957

APPENDIX

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UNITED STATES DISTRICT COURT

District of Connecticut

JAMES R. WATKINS AND LUCILE L. WATKINS,
Plaintiffs

vs.

UNITED STATES OF AMERICA,
Defendant.

Civil Action No. 5052

DOCKET ENTRIES

August 20, 1954

Complaint filed—Summons issued.

August 25, 1954

Marshal's return showing service, filed—summons.

October 22, 1954

Stipulation extending time to answer or plead, filed.

December 23, 1954

Answer filed.

March 8, 1956

Pre-trial Order entered. Smith, J. Copies mailed counsel.

June 26, 1956

Motion of defendant for leave to file amended answer and Notice of motion filed.

July 2, 1956

Hearing on motion of defendant for leave to file amended answer. Motion granted. Anderson, J.

July 12, 1956

Motion for judgment on the pleadings filed (by plaintiffs) together with Notice of motion.

December 7, 1956

Notice of taking deposition of W. Emery Lancaster and A. W. D. Weis filed.

December 17, 1956

Depositions of A. W. D. Weis and W. Emery Lancaster filed.

December 21, 1956

Court trial commences—two witnesses for plaintiffs sworn and testified. Plaintiffs' Exhibits A, B, C, D, E and F admitted into evidence. One witness for defendant testified (a plaintiff witness called by defendant as its own). Both parties rest. Plaintiffs to file briefs by noon on January 11, 1957. Defendant to mail its brief to Judge Anderson at Noank by January 31. Plaintiffs to file reply by February 8, 1957. Anderson, J.

February 14, 1957

Court Reporter's notes filed.

March 12, 1957

Findings of Fact, Conclusion of Law and Discussion filed and entered. Anderson, J. Copies mailed counsel. Judgment with costs may enter in favor of the defendant.

March 12, 1957

Judgment entered dismissing action on merits, defendant to recover costs. Earl, C. Copies mailed counsel.

March 20, 1957

Taxation of Costs entered. Earl, C.

March 22, 1957

Motion for extension of time for filing motion to amend findings and make additional findings filed. Motion granted. Anderson, J.

April 10, 1957

Notice of Appeal filed by plaintiffs. Copies mailed U. S. Attorney. $250 received as appeal bond.

TESTIMONY AT TRIAL

Kennett Wade Dillman, being duly sworn, testified as follows:

Questions by Mr. Weir

* * * *

Q. During the period from 1937 to early 1940, did you have any conversations with Mr. Watkins with reference to a change in the license agreement between him and Dillman Industries? A. Yes. There was quite a few—a few conversations, because we were trying to develop the manufacture of the container and expand the sale of it. And we were interested to the extent that we thought it could be greatly expanded but it would have to be done through other means than just Dillman Industries. We would have to make some other arrangements to do it.

Q. Had Dillman Industries attempted to exploit the use of the license while it had its own license? I will withdraw that question. What had Dillman Industries done, during the period that it had its license, to increase the use of the box? A. Well, we had Mr. Watkins out trying to make sales, and get the box generally accepted on the market. And on my end of the line at the plant, I had spent a lot of time and we of course had spent a lot of money on trying to make the box, to get it set up where it could be made on an efficient mass-production basis. And this we discussed with Mr. Watkins. He was anxious to get the box more generally accepted across the country, and the only way that could be done would be to license others to do it.

Q. Had Mr. Watkins licensed others? A. There had been, I think, one or two other licenses, yes, sir.

Q. What was the purpose of these conversations between you and Mr. Watkins with reference to a new arrangement between Dillman Industries and Mr. Watkins? A. Well, Mr. Watkins talked to myself and to Mr. Weiss from time to time stating what his ideas were with reference to expanding the use of the Watkins

box and licensing others to make it. And we told Mr. Watkins—I say we—and in conversation, Mr. Weiss and myself with Mr. Watkins, that we wanted to do that, too. But we were not willing to go ahead with this thing unless we could have the complete ownership of it, because we realized we were going to have to spend an awful lot of money. When we finally did go ahead, we spent over $50,000 on one experimental machine.

(Tr. pp. 13, 14)

* * * *

Question by the Court

Q. You say that you wanted something more than a license. You wanted to own the patent; is that it? A. That is right. If we were going to go ahead and put more money in it and expand this operation, yes, sir. (Tr p. 15)

* * * *

Questions by Mr. Weir

Q. You tell us, or tell the Court if you will, what you remember as to what Mr. Watkins said or you said or what Mr. Weiss said with respect to the making of a new arrangement regarding these patents. A. Well, Mr. Watkins said that he wanted to expand the use of the patents and he realized to do it would take considerable amount of financing or money, which he didn't have. And I stated to Mr. Watkins that I was in agreement with him with the idea of expanding this, and I thought we could work it out, although I didn't think it was proper to be done by Dillman Industries as a corporation. And Mr. Weiss stated that he was willing to go along with it and to have Dillman Industries provide the financing for it, but only so long—we told Mr. Watkins very definitely at that time—that only so long as we had ownership of the patents. (Tr. p. 17)

* * * *

Q. During the course of these conversations between Mr. Watkins, yourself and Mr. Weiss, was anything said about a license from Watkins Patents to Mr. Watkins? A. Yes.

Q. What was said on that point? A. Well, Mr. Watkins made it a part of his deal—in other words, in assigning these patents to Watkins Patents, he insisted that he have a license from Watkins Patents to protect his interests. In other words, he might be let out by Dillman Industries and there he would be, without any patents, without anything. And so that was a consideration in transferring the ownership from himself to Watkins Patents, that he in turn received a license that he might use at any time, anywhere.

Q. From Watkins Patents? A. From Watkins Patents, yes, sir. (Tr. pp. 20, 21)

* * * *

Q. Was anything said during the course of these conversations about the license that was in existence from Mr. Watkins to Dillman Industries? A. Yes. That came up.

Q. What was said by the parties? A. Well, Dillman Industries stated that they would want a license from the new company because, although they had a license from J. R. Watkins, they wanted a license from Watkins Patents, Incorporated. And that was arranged. (Tr. pp. 21, 22)

* * * *

Q. Now, as a result of these conversations, were any agreements drawn up? A. Yes.

Q. Who prepared the agreements? A. Attorney Lancaster.

Q. His full name is W. Emory Lancaster; is that correct? A. That is correct.

Q. Where was his office located? A. Quincy, Illinois.

Q. Do you know for whom he was acting as attorney? A. He was acting as attorney for Dillman Industries.

Q. Do you know what he was told as to the agreement of the parties with respect to this new arrangement? A. Yes, sir. He was instructed to prepare these agreements between Mr. Watkins and Dillman Industries. And he was told and instructed that Mr. Watkins was transferring the patents from his own personal ownership to Watkins Patents and that we had agreed on the various points. And he was instructed to go ahead and prepare the agreement. (Tr. pp. 22, 23)

* * * *

Q. Do you know whether or not Watkins Patents, Incorporated set up a fund to take care of patent infringement litigation? A. We did.

Q. Do you know whether or not the creation of such a fund was discussed by you and Mr. Watkins and Mr. Weiss at the time of the discussions you have testified to? A. Yes, sir, it was.

Q. What was said by the various parties about that? A. Well, Mr. Watkins stated that he did not have the necessary finances to fight or to defend any infringement suit, and he wanted Dillman Industries or Watkins Patents to establish that fund so that it could be offered as a protection.

Q. And we stated that we would. On his assigning patents to Watkins Patents, we would establish that fund. We agreed to do it. (Tr. p. 29)

* * * *

Q. Now, following the signature of these agreements and the organization of Watkins Patents, were there any discussions between the officers of Watkins Patents as to the licensing of particular persons or individuals, do you recall? A. Yes, sir. There was quite a few of them. (Tr. p. 30)

* * * *

Q. Between whom did these discussions take place? A. Between Mr. Weiss and Mr. Watkins and myself.

Q. What was said by these various persons during the discussions? A. Well, they were mainly—came about in the fact that one of us would propose somebody—an individual or company, as a prospective licensee, or would present it, if the person had applied for a license. And the three of us would discuss as to whether or not we—if I proposed it, Mr. Weiss and Mr. Watkins would discuss it, as to whether or not the proposal was acceptable, or not. They often became quite heated.

Q. During those discussions was anything said about ownership of these patents? A. Well, you have already met Mr. Weiss and you know him, and he had become quite excited. He, many times, would call the attention to both Mr. Watkins and myself by shaking his finger and saying, "We own this patent. You don't have a damn thing to do with it now."

Q. What would Mr. Watkins say to that? A. He wouldn't say anything. That usually ended the argument right there.

(Tr. pp. 31, 32)

* * * *

Question by Mr. Gitelman

Q. At that time Dillman Industries was making boxes; is that correct? A. We were making various types of boxes.

Q. Yes. And then you decided that you would create a new organization whose purpose it would be to handle the sub-licensing of the Watkins' patents? A. Well, we created the new corporation so that it could handle the licensing end of it. We didn't want that involved in Dillman Industries.

Q. That is, the Watkins Patents, Incorporated sole job was to handle the sub-licensing? A. It was to handle the licensing of licensees.

Mr. Weir. I object to that, your Honor. I don't recall any testimony to that effect.

The Court. Well, obviously it would include the interest in the patents, the holding of the interest in the patent. Is that the objection?

Mr. WEIR. Well, that is the objection. I think he used the word "sole."

The COURT. He said "solely." By that you didn't mean, I take it, to exclude the patents because they couldn't very well grant licenses if they didn't have any interest in the patents?

Mr. GITELMAN. No. What I am driving at is that Watkins Patents, Inc. was not created to manufacture boxes.

A. No, we didn't.

* * * *

Question by the Court

Q. Do you, Mr. Dillman, mean that all that Watkins gave to Watkins Patents, Incorporated, or transferred to them, was an exclusive non-transferable right, but that ownership was retained by Watkins? A. That was not my understanding of it, no. In other words, I understood that we owned the licenses; in other words, that they were assigned to us. I don't know about the terminology here but— (Tr. p. 41)

* * * *

Question by Mr. Gitelman

Q. In other words, it was your understanding that that 1941 patent passed immediately to Watkins Patents Incorporated under this agreement? A. That was my understanding, that anything, any and all patents that he might obtain in the future, would be assigned to Watkins Patents.

Q. By "assigned" do you mean "would immediately pass on to" Watkins Patents under the basic agreement? There would be no need for any further agreement. A. No. He was to turn over everything to Watkins Patents and we were to pay the bills. (Tr. pp. 43, 44)

* * * *

James R. Watkins, being duly sworn, testified as follows:

Questions by Mr. Weir

* * * *

Q. What were the purposes of these conversations with the two Dillmans and Mr. Weiss? A. Well, I realized at the time that I could not—I didn't have the finances to protect the patents against infringement. And I also realized that I could not in the time that I had to sell the container, to promote it—that I could not take advantage of the prospects for selling the container. I couldn't cover the field. So I entered into conversation about them taking over and buying these patents so that some arrangements, through the finances which they did have—I would have protection and that others would be licensed to manufacture.

Q. At this time was Dillman Industries a successful corporation, do you know? A. Yes. They were successful and they had a new plant there which impressed me, that they were progressive. I thought they would do a good job promoting.

Q. In the latter part of '39 and the early part of 1940, did you have some conversations on this subject with Mr. Weiss and Mr. Dillman? A. Yes.

Q. Will you kindly tell the Court what was said by you, by Mr. Weiss and by Mr. Dillman during the course of these conversations concerning a new arrangement with respect to the patents? A. Well, I believed at that time, and it proved later, that Mr. Weiss who was a man of considerable means financially—he was well known in the industry. So I approached first Mr. Dillman because I had met him when I first left college and knew he had this manufacturing plant, with the idea of getting them to make this container. Dillman referred me to Weiss who was financial backer of Dillman Industries. So with that background I felt secure in approaching Mr. Weiss with the understanding that his company, or he, buy these patents and promote them. Well, he said that they were interested in it. They were manufacturers at

that time principally of egg cases and meat boxes. And that business was deteriorating to some extent. And they wanted something additional to come into their plant. So he was open to suggestion there that they become interested in this container. And he said he would. He would consider and he would talk it over with Frank Dillman. So after a while, possibly a couple of months or so, the question came up some more. And they said that they would purchase these patents and they—in the course of events, as we talked about what I wanted for them, I asked him—told him that I wanted certainly what I had paid the patent lawyer for developing them and that I wanted to participate in the earnings of the containers which were manufactured under the patent. Then—Mr. Weiss then said that in his opinion this new company should be organized to take over the patents and promote them separate from Dillman Industries itself. And that led up to the point where I, after considerable conversation, led up to the point where they agreed to pay me for the patents, and led up to this agreement which Mr. Lancaster drew up.

(Tr. pp. 51, 52, 53, 54)

* * * *

Q. These agreements—they were executed in April 1940—covered all of the patents which you then owned; is that so? A. That is right.

Q. Was a new patent issued to you subsequent to the execution of these agreements? A. Yes. There was a patent issued about '41 or so.

Q. Do the licenses issued by Watkins Patents include rights under the patent issued in 1941? A. Yes.

Q. In other words, the licensees from Watkins Patents operate under all of the patents that have been issued to you? A. Yes. It is my understanding that any new container or patent I receive on a combination corrugated and wood fibre container becomes a part of this agreement.

Q. When the patent was issued to you in 1941, did you execute any document transferring it to Watkins Patents, Incorporated? A. I don't recall that I did. I just turned the patent over to Watkins Patents at one of the meetings, and that is all I did about it. (Tr. pp. 56, 57)

* * * *

Q. In connection with this patent issued in 1941, you made the application in your own name, did you not? A. Yes, that is right.

Q. Did you pay the expenses of that application? A. No. I never paid any. After this patent, Watkins Patents, Incorporated was organized—I never paid any expense—lawyers or traveling or any other expense, in connection with obtaining patents.

Q. Who paid those expenses? A. Watkins Patents, Incorporated.

Q. Have you made any application for patents since 1941? A. Yes. There is a patent pending now.

Q. Did you pay any of the expenses in connection with that application? A. No, no.

Q. Who paid those expenses? A. Watkins Patents, Incorporated. (Tr. pp. 57, 58)

EXHIBIT F

A. W. D. Weis, being duly sworn, testified as follows:

Questions by Mr. Weir

* * * *

Q. While Mr. Watkins was in the employ of Dillman Industries, did you have any conversations with him about those patents? A. Sure we did. I couldn't identify any particular conversation but he was in our employ and we talked about the patents right along.

Q. Was there any conversation about a new arrangement under the patents? A. Yes, before we made this contract here.

Q. Do you recall any specific conversations? A. No, I don't.

Q. Do you recall where the conversations were held? A. There was a desire for a wider distribution of the Watkins patents—can I tell this my own way then I'll get it straight—we were making that territory over there and there were some other parties—we were stepping on their toes—the contracts they had. They wanted a license—all right, we objected to some of the licenses for the reason that we were supplying them. We worked up the business. We didn't think it was right for him to put in other licenses. From the ramification just came the idea we better get together and have control of the patents and we would know how to handle it, and list the patents through anybody we wanted to—Watkins had the say so—if he said "No," we couldn't do it.

Q. As a result of these conversations, was a new corporation formed? A. Yes.

Q. What was the name of the new corporation? A. Watkins Patents, Inc. (Tr. pp. 80, 81)

* * * *

Q. As a result of those conversations, did you instruct Mr. Lancaster to prepare these agreements? A. We came up and talked and made notations, had some tentative contracts which we corrected and had to re-write them till we got what we wanted. We wanted what Watkins wanted. It wasn't really an easy contract to draft, to tell you the truth about it. Watkins was selling something, we were buying something. (Tr. p. 83)

* * * *

Q. When you signed those agreements in behalf of Watkins Patents, what were your intentions with respect to the ownership of those patents? A. For the life of the patents and any improvements thereon, we would have them.

Q. By "we" you mean Watkins Patents? A. Yes.

(Tr. p. 84)

* * * *

Questions by Mr. Gitelman

Q. In your examination—direct examination—you indicated that Watkins had the say-so, by that do you mean that Watkins made it clear he wanted to have the power to object to such licenses as you might want to issue? A. No, he knew the people better than we did. He knew whether we should issue the license or not—we didn't want to have too many licenses in a territory—that we would have a tendency to cause price cutting and friction with our licenses. We wanted licenses, but we wanted to distribute them in a territory that could consume them without cutting each others throats. We just let Mr. Watkins sort of figure that out. (Tr. p. 85)

* * * *

Q. Did Watkins Patents, Inc., ever get into any ligation on patent infringements? A. No, we had a fund set aside, but we never had to use it. In fact I think the original contract provides for that. We complied with that. (Tr. p. 87)

* * * *

EXHIBIT F

W. Emery Lancaster, being duly sworn, testified as follows:

Questions by Mr. Weir

Q. What is your present occupation? A. I am an attorney.

Q. You are admitted to practice in the State of Illinois? A. I have been practicing in the State of Illinois for fifty years. I have a certificate on the wall over there. (Tr. p. 88)

* * * *

Q. As a result of these discussions you prepared certain agreements? A. They gave me facts and I prepared agreements.

Q. What did they tell you? A. It seemed that the Dillman Industries had a license, under a patent with Watkins in 1937, in

fact I made a memo of it and in 1940 the idea was to sell the patents, I think there were four if I remember rightly, to this new corporation, Watkins Patents, Inc., that is in 1940 and this was done. Papers were drawn accordingly and after it was done I think the provisions provided that the license which Dillman had enjoyed from Watkins was cancelled and a new license was issued to Dillman from the Watkins Patents, Inc. There were many things that entered into the contract, if you want to ask more specific questions. (Tr. pp. 88, 89)

* * * *

FINDINGS OF FACT

(Caption omitted) (Tr. pp. 149-163)

1. On April 17, 1934 there was issued to the plaintiff, James R. Watkins, U. S. Letters Patent No. 1,955,107 covering a wood cleated corrugated shipping container.

2. Subsequently, additional Letters Patent were issued to him for improvements on the shipping container as follows:

October 9, 1934, Letters Patent No. 1,976,693;
December 27, 1938, Letters Patent No. 2,141,497; and
May 13, 1939, Letters Patent No. 2,159,642

3. In March 1937 the plaintiff, James R. Watkins, entered the employ of Dillman Industries, Inc. of Caruthersville, Missouri, manufacturers of lumber, wooden boxes and crates, and at that time entered into an agreement with Dillman Industries, Inc. whereby Watkins granted to the corporation a non-exclusive license to manufacture containers under the patents which, up to that time, had been issued to him.

4. The manufacturing and sales of the shipping containers proved to be successful and early in 1940, after the last two patents relating to the shipping container had been issued to Watkins, negotiations went on between James R. Watkins and some of the

officers and leading shareholders of Dillman Industries, Inc. acting both on behalf of the corporation and themselves personally, relative to new agreements for the exploitation of the patents.

5. During said period a new corporation, Watkins Patents, Inc., was organized under the laws of the State of Illinois in which the plaintiff, James R. Watkins, owned twenty per cent of the shares issued and outstanding and the remaining eighty per cent of said shares were owned by Dillman Industries, Inc. or officers and shareholders of Dillman Industries, Inc.

6. On April 17, 1940 the four patents above referred to were the subject of five agreements entered into, eodem instante, which may generally be summarized as follows:

(a) An agreement between James R. Watkins and Watkins Patents, Inc. by which Watkins transferred to Watkins Patents, Inc. a non-transferable exclusive license for the use of and sub-licensing under the patents. By the same agreement Watkins Patents, Inc. agreed to pay Watkins $3,600 in cash and twenty per cent of the stock in Watkins Patents, Inc. and one-third of the net royalties derived from licensed manufacture under the patents, subject to certain minor qualifications. Said contract provided further that Watkins had a non-transferable, non-exclusive sub-license under the patents, and that anyone with whom he became associated to practice his sub-license had a right to sub-license from Watkins Patents, Inc. even after the termination of the association between Watkins and such individual, co-partnership or corporation. Said agreement further provided that in the event of litigation concerning said patents, or any of them, Watkins Patents, Inc. had a duty to defray the cost of such litigation up to the amount of $10,000 and that with regard to expenditures above said amount Watkins Patents, Inc. had the option of paying the additional amount necessary or to refuse to do so, in which event said James R. Watkins had the right to carry on such litigation at his own expense with certain provisions for reimburse-

ment in the event of his successful prosecution or defense of said litigation. Said contract further provided that sub-licenses of Watkins Patents, Inc. were subject to the approval of James R. Watkins and that all existing licenses were transferred to Watkins Patents, Inc. by James R. Watkins. The contract also provided that Watkins Patents, Inc. had a duty to account to Watkins and that copies of the contract and assignments of prior licenses should be in proper form for filing in the U. S. Patent Office.

(b) An agreement between Watkins Patents, Inc. and Dillman Industries, Inc. by which Dillman Industries received a non-transferable, non-exclusive license to manufacture and sell containers under the patents of Watkins Patents, Inc. in return for its payment to Watkins Patents, Inc. of royalties of one per cent of the net sales of containers sold under the license, such royalties to become one and one-half per cent in case the employment of James R. Watkins by Dillman Industries, Inc. was terminated.

(c) An agreement between Dillman Industries, Inc. and James R. Watkins by which a license previously granted to Dillman Industries, Inc. by Watkins was canceled. This agreement provided further that Watkins' employment contract with Dillman Industries, Inc. was terminated and a new employment contract entered into, under the terms of which Dillman Industries, Inc. was to pay Watkins $400 per month and twenty-five per cent of Dillman Industries' net income from the manufacture and sale of products under Watkins Patents. At the end of any year either party could terminate the employment contract by giving notice. The agreement also contained certain provisions concerning the holding by Watkins of stock in Dillman Industries, Inc.

(d) An agreement between James R. Watkins, Dillman Industries, Inc. and Watkins Patents, Inc. which incorporated agreement (a) above, canceled a previous license given by Watkins to Dillman Industries, Inc. and provided for the execution of a sub-license to Dillman Industries, Inc. from Watkins Patents,

Inc. (agreement (b) above). The agreement contained certain other provisions, including Dillman Industries' promise to loan Watkins Patents, Inc. certain amounts for the purpose of paying litigation expenses that might arise in defense of Watkins' patents.

(e) An agreement between Watkins Patents, Inc. and James R. Watkins by which Watkins Patents, Inc. purported to grant James R. Watkins a non-transferable, non-exclusive license to manufacture and sell containers under the Watkins Patents in return for royalty payments of one and one-half per cent of the net sales of such containers. The agreement further provided that said license was not to be used by James R. Watkins as long as he was employed by Dillman Industries, Inc.; but that upon leaving the employment of Dillman Industries, Inc., (which at his option he might do at the end of any year) he might operate under the license, or if he became associated with any individual, co-partnership or corporation, such enterprise might manufacture and sell under his license. The agreement provided that upon termination of Watkins' association with any such individual, co-partnership or corporation, such individual, co-partnership or corporation would have the right to obtain a license from Watkins Patents, Inc. The agreement expressly provided that Watkins, upon termination of such associations, might continue to use his license individually or enter into subsequent associations, one at a time, with other individuals, co-partnerships or corporations, which could use his license during the period of association and obtain a license from Watkins Patents, Inc. upon termination of the association.

7. The agreement between James R. Watkins and Watkins Patents, Inc. did not transfer from James R. Watkins to the corporation, nor did the parties intend that it should transfer, all the substantial rights to the patents.

Conclusions of Law

1. This court has jurisdiction of the subject matter and of the parties in this action.

2. The agreement between James R. Watkins and Watkins Patents, Inc. did not constitute a sale or assignment of the patents but was only the grant of a license.

3. The income reported by the plaintiffs in their 1949 through 1952 returns and derived from the licensing by James R. Watkins of Watkins Patents, Inc. was ordinary income and not capital gains.

Discussion

The question presented is whether the items of income received by the plaintiffs for the years 1949 through 1952 and derived from agreements with Watkins Patents, Inc. concerning Watkins' patents were ordinary income as set out in the tax returns which they filed for those years, or were actually capital gains from a sale of assets held for more than six months under Sec. 117(a) Internal Revenue Code of 1939 as to the calendar years 1949 and 1950, and Sec. 117(q) Internal Revenue Code of 1939 as to the calendar years 1951 and 1952. The plaintiffs assert that they were capital gains and in this action they are suing for a refund.

It was stipulated by the parties at the trial that testimony might be received from the plaintiffs, relative to the history of the parties to the contracts referred to in the finding, the business relationship of the parties and the negotiations before and during the making of the agreements as well as some testimony as to what the parties to the contracts actually did pursuant to them. This was received with the understanding that the court, after hearing all of the evidence and arguments in the case, would rule upon the defendant's objection that such parol testimony was inadmissible

as an effort to vary the terms of the written contract. That objection is overruled and the subsequent motion by the defendant to strike is denied.

It is the Government's claim that what the patentee, Watkins, transferred to Watkins Patents, Inc., was a mere license rather than an assignment or sale of the patents. It relies upon that part of the opinion in *Waterman* v. *Mackenzie*, 138 U. S. 252 at pages 255 and 256 which in effect says that the grant of anything less than the "right to make and the right to use and the right to sell" is not an assignment or sale of a patent. See *Broderick* v. *Neale*, 201 F. 2d 621 (Tenth Cir.). While the plaintiffs are correct in pointing out that there is no absolute requirement that the precise language of this trilogy be used or that exact synonyms for "make," "use" and "sell" be set out in the agreement of transfer, nevertheless, the agreement must in the language it employs in the context of the case convey all substantial rights to the patent, and the language used must be broad enough for this purpose. The plaintiffs claim that the wording used by James R. Watkins in the agreement with Watkins Patents, Inc. "does hereby transfer and grant . . . the non-transferable exclusive license for the use of and sub-licensing under each and all . . . the patents" is sufficient. Under certain circumstances and in certain contexts such as imprecise expression of assignment or sale could be so construed. *Reid* v. *Commissioner*, 26 T. C. 78; *Associated Patentees Inc.* v. *Commissioner*, 4 T. C. 979; *Daily* v. *Universal Oil Products Co.*, 76 F. Supp. 349 (D. Ill.); and *Pike* v. *U. S.*, 101 F. Supp. 100 (D. Conn.). These and other cases also state that the use of the word "license" instead of the words "assign" or "sell" is not in itself conclusive. It is, however, something which may be considered with the other facts and circumstances of the case to determine what the operative intent of the parties was. *E. W. Bliss Co.* v. *U. S.*, 253 U. S. 187. *In Switzer* v. *Commissioner of Internal Revenue*, 226 F. 2d 329 (Sixth Cir).

at page 330 the court, after citing *Waterman* v. *Mackenzie*, supra, and two Sixth Circuit cases said:

> ". . . Those cases also point out that whether the instrument constitutes an assignment or a license does not depend upon the name by which it is called, but upon the legal effect of its provisions.
>
> "However, it is also the rule that while such words in a license agreement give rise to an assignment of a patent where the document granting such a license is consistent with a present intention by the owner to transfer the patent, they can not be held the equivalent of an assignment where the document itself and the total factual complex surrounding the transaction negatives such a transfer. Although no particular form is required for an assignment, the instrument of transfer must be unambiguous and show a clear and unmistakable intent to part with the patent. . . ."

In the present case five written agreements were executed and delivered at the same time and they must all be construed together. What the parties intended by a particular phrase or provision in the agreements must be found from the language itself, its context in the written instrument of which it is a part and the other four agreements, all considered against the background of the surrounding circumstances. Such a study makes it apparent that what was transferred by Watkins to Watkins Patents, Inc. was the power to license or, as the court described it in *Six Wheel Corporation* v. *Sterling Motor Truck Co.*, 50 F. 2d. 568 (Ninth Cir.) at 573, "the license to license."

Looking at the facts of the case in their broadest aspect, James Watkins owned certain patents in connection with which there was promise of considerable demand from various manufacturers for licenses from which profitable royalties could be realized. To promote the dissemination of licenses, to provide for means to protect the patents in infringement actions, and to establish offices to handle the business of the licenses, royalty accountings, etc.,

required money which Watkins did not have. Dillman Industries, Inc. already had, and for some time had used, a license to manufacure and sell Watkins' patented container, and Watkins had an employment contract with Dillman Industries, Inc. The individuals who owned controlling interests in Dillman Industries, Inc. had the necessary capital to promote the licensing under Watkins Patents and saw an opportunity to make a profit in doing so in a field with which they were familiar. To limit the responsibilities of themselves and Dillman Industries, they agreed with Watkins on the organization of Watkins Patents, Inc. through which the financing and promotion of licensing would be carried on. The power to license with the incidental protective right to conduct or participate in infringement actions, and the rights in outstanding licenses were the only incidents of ownership which any of the parties intended to have conveyed and were in fact the only interests conveyed by James R. Watkins to Watkins Patents, Inc. This purpose and intention is clearly expressed in the agreement between James R. Watkins, Party of the First Part, Dillman Industries, Inc., Party of the Second Part and Watkins Patents, Inc., Party of the Third Part, where it says:

> "First Party is desirous of having a wider and more general use of, and more extensive manufacture of containers covered by his patents, and to accomplish this has approached and proposed to Second Party that Second Party enter into a contract with him for the exclusive handling of his patents by means of licensing various individuals and firms throughout the United States of America to manufacture crates under the above referred to patents owned by First Party.
>
> "Second Party realizes and sees the advantage of such an arrangement and has caused to be organized under the laws of the State of Illinois a corporation, Party of the Third Part under this agreement, known and designated as Watkins Patents, Inc. . . ."

Where the granting clause of the Watkins—Watkins Patents, Inc. agreement says " . . . license for the use of and sub-

licensing under," it is also clear from its context, the surrounding circumstances and the witnesses' testimony, particularly Mr. Dillman's, that "use" meant the exploitation of the patents by issuing licenses. Its meaning was intended by the parties to be limited to this alone; it did not intend a conveyance of all of the substantial rights in the patents, and it did not mean or include either the right to manufacture or the right to sell or the right to use the product. In his testimony Mr. Dillman said, "He (Mr. Watkins) was anxious to get the box more generally accepted across the country and the only way that could be done would be to license others to do it. . . . Mr. Watkins talked to myself and Mr. Weiss from time to time stating what his ideas were with reference to expanding the use of the Watkins box and licensing others to make it. . . . We created the new corporation so that it could handle the licensing end of it." In response to a proper question on cross-examination, "That is, the Watkins Patent, Inc. sole job was to handle the sub-licensing?" he replied "It was to handle the licensing of licensees."

The plaintiffs' witnesses in their testimony frequently talk of the transfer by Watkins to Watkins Patents, Inc. of "complete ownership" or "ownership" of the patents and that the controlling interests in Dillman Industries would not have entered into financing Watkins Patents, Inc. without such complete ownership. It is significant, however, that neither any such words nor their legal equivalents were used in the lengthy written agreements drafted by their counsel; and the claim must be rejected. The individuals financing Watkins Patents, Inc. sought and received for Watkins Patents, Inc., which they controlled, only the power, exclusive (except for what was kept in the hands of Watkins), to grant licenses under the patents and to have the right to royalties flowing from the licenses issued. Their interest was financial; and to protect their investment and insure their prospects for profit, they neither sought nor needed to have Watkins Patents, Inc. vested with the rights to manufacture or sell or use the

products of the patents or any rights other than the legal interests conveyed to Watkins Patents, Inc., i.e., the power to license and the right to a share in the royalties.

The question in this case may be approached in another way. Even if it is assumed, as plaintiffs claim, that all the legal relations which go to make up ownership of the patents were transferred in the granting clause in the agreement between James R. Watkins and Watkins Patents, Inc., many legal interests out of the whole bundle of legal interests which constitute ownership found their way back into the hands of James R. Watkins as a result of the whole transaction set out in the five agreements. The question, therefore, may be put in this fashion: For income tax purposes what legal interests may still remain in the hands of the patentee who purports to sell his patents to another without reducing that sale to a grant of a license?

After the agreements became operative, Watkins had an employment contract with Dillman Industries, Inc. which after one year he could terminate at will. Upon such termination he had a license to practice the patents and the power to require Watkins Patents, Inc. to license any individual, co-partner or corporation with whom Watkins had associated himself for manufacturing and selling the products and from whom Watkins had dissociated himself; and Watkins had the power to disseminate licenses in this manner by making and breaking such associations without limit. Watkins had a veto power in the requirement of his approval of any licenses granted by Watkins Patents, Inc. He was a substantial though minority shareholder of Watkins Patents, Inc. He could compel Watkins Patents, Inc. to finance infringement litigation up to $10,000 in cost and above that amount, if the corporation did not choose to do so, he had either to bear the responsibility himself with right of reimbursement only if he were successful or withdrew from the actions. The legal interest granted by Watkins to Watkins Patents, Inc. was non-transferable. Watkins was to be paid in part by a share in royalties;

and a default by the other parties in certain obligations under the agreements would work a termination of their interests in the patents and a return of those interests to Watkins.

Thus, while James R. Watkins transferred with his right hand a bundle of legal interests which he claims constituted complete ownership, he took back with his left hand a substantial number of those interests. Because of the special status of patents and the favorable attitude of Congress toward inventors, the courts, in construing agreements in the course of determining tax liability, have permitted inventors to retain some legal interests in the nature of safeguards for royalty payments and to prevent the shelving or misuse of patents. *Koe* v. *U. S.*, 138 F. Supp. 567 (S. D. Texas) at 570, and *Kronner* v. *U. S.*, 110 F. Supp. 730, 734 (U. S. Court of Claims).

An assigning patentee may have an interest in or be employed by a corporate assignee, *Hofferbert* v. *Briggs*, 178 F. 2d 743 (Fourth Cir.); and the purchase price for the patents may be paid in royalties. *Watson, et al.* v. *U. S.*, 222 F. 2d 689 (Tenth Cir.); *First National Bank of Princeton* v. *U. S.*, 136 F. Supp. 151, 822 (D. N. J.). See: *Block* v. *U. S.*, 200 F. 2d 63 (Second Cir.) 1952; Title 26 U. S. C. Sec. 1235. He may reserve to himself or have the assignee transfer to him a license to practice the patent. *Kavanagh* v. *Evans*, 188 F. 2d 234 (Sixth Cir.); *Crook* v. *U. S.*, 135 F. Supp. 242, 253 (W. D. Penn.). He may require that the transferee obtain his consent for each license issued. *Thompson* v. *Johnson, Collector*, 50-2 U. S. T. C. 9428. He may prohibit the transferee from further assigning the interests conveyed. *Watson, et al.* v. *U. S.*, 222 F. 2d 689, 691 (Tenth Cir.); *Crook* v. *U. S.*, 135 F. Supp. 242, 252 (W. D. Penn.); *Dreymann* v. *Commissioner*, 11 T. C. 153, 161. He may retain rights and duties in connection with prosecuting and defending infringement suits. *First National Bank of Princeton* v. *U. S.*, 136 F. Supp. 818, 822 (D. N. J.). He may retain the power to transfer the license which he reserved or which was set over to him by his

assignee to one other person if he himself does not elect to use it. *Kavanagh* v. *Evans*, 188 F. 2d 234 (Sixth Cir.). He may reserve the right to cancel upon the breach of some duty assumed by the assignee, such as assisting in prosecuting or defending the patent in infringement actions or paying royalties or upon the happening of some future event beyond the assignor's control which renders continuance of the agreement impractical. *Littlefield* v. *Perry*, 88 U. S. 205, 220; *Allen* v. *Werner*, 190 F. 2d 840 (Fifth Cir.); *First National Bank of Princeton* v. *U. S.*, 136 F. Supp. 818, 822 (D. N. J.); and *Dreymann* v. *Commissioner*, 11 T. C. 153, 161.

While in the cases cited an assignment or sale was not reduced to a license because there remained in the hands of the assigning patentee two, three or four of the legal interests mentioned, there is no case where all of them were held in his hands; and in the cases where a number of such interests remained in the patentee, there was a stronger context and evidence of intention to sell or assign than in the present case. It is necessary to draw the line somewhere, and it seems plain that Watkins came out of the agreements with such extensive interest that even assuming, arguendo, an initial assignment in the granting clause of the contract between him and Watkins Patents, Inc., he finally as a result of the whole transaction, conveyed no more than a license. In making this overall determination, this court is mindful of the apparent intent of Congress:

> "The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the rights to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a 'sale or exchange' under existing law, with the exception noted relating to contingent payments, which exception is justified in the patent area for 'holders' as herein defined.

> . . . Moreover, the courts have recognized that an exclusive license agreement in some instances may constitute a sale for tax purposes even where the right to 'use' the invention has not been conveyed to the licensee, if it is shown that such failure did not represent the retention of a substantial right under the patent by the licensor. It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee rather than recognizing less relevant verbal touchstones. . . ."
> *Report of the Committee on Finance, United States Senate,* to accompany H.R. 8300, dated June 18, 1954, page 439.

In none of the cases decided in favor of a patentee is there an example of the retention of such extensive powers as there is in those which Watkins kept to himself. Once he had left the employ of Dillman Industries, Inc., which he could do at his own volition after a year, Watkins could associate himself with another to manufacture and sell and that other would gain and retain a license even after Watkins had become disassociated from him; and thereafter Watkins could make a new association with someone else, who would thereby also gain a license and so on without limit. At the same time he could veto the granting of licenses by Watkins Patents, Inc. to someone of whom he did not approve. He possessed power to do more than his transferee could do.

After considering all of the evidence and the claim of the parties, it must be concluded that the plaintiffs have failed to establish that James R. Watkins and those contracting with him either intended or accomplished a sale or assignment of the patents to Watkins Patents, Inc. and that the payments in question must be treated as ordinary income and not as capital gains.

Judgment, with costs, may enter in favor of the defendant against the plaintiffs.

Dated at New Haven, Connecticut, this 12th day of March, A. D. 1957.

ROBERT P. ANDERSON
United States District Judge

(SEAL)

JUDGMENT

(Caption omitted) (Tr. p. 164)

This cause came on to be heard on December 21, 1956, and was argued by counsel, and thereupon, upon consideration thereof, the Court filed its "Finding of Fact, Conclusions of Law and Discussion" which provides that judgment, with costs, may be entered in favor of the defendant against the plaintiffs.

It is accordingly Ordered, Adjudged and Decreed that the plaintiffs take nothing, that the action be and it hereby is dismissed on the merits and that the defendant have and recover from the plaintiffs its costs in the action.

Dated at New Haven, Connecticut, this 12th day of March, 1957.

GILBERT C. EARL, Clerk

Approved as of March 12, 1957.

ROBERT P. ANDERSON,
United States District Judge

No. 10[illegible]
24663

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IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

No.

JAMES R. WATKINS and LUCILE L. WATKINS,
Appellants

v.

UNITED STATES OF AMERICA,
Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF CONNECTICUT

BRIEF AND APPENDIX FOR THE APPELLEE

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25
1957

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The royalties received by taxpayer as transferor of patent rights constituted ordinary income, because taxpayer did not transfer all substantial rights to the patents within the meaning of Section 117(q) of the 1939 Code, or sell the patents within the meaning of Section 117(a)(4) of the same Code	12
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CITATIONS

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BRIEF FOR THE APPELLEE

Opinion Below

The findings of fact, conclusions of law and opinion of the District Court (R. 16-29)[1] are reported at 149 F. Supp. 718.

Jurisdiction

This appeal involves individual income tax liability for the years 1949 through 1952. (R. 20.) The judgment of the District Court was entered on March 12, 1957. (R. 29.) Taxpayers' notice of appeal was filed on April 10, 1957.

[1] Record references herein are to the appendix to taxpayers' brief.

(R. 4.) Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

Question Presented

The ultimate question is whether royalties received by the taxpayer[2] as transferor of certain patent rights constituted ordinary income or capital gain. For the years 1949 and 1950, the answer depends upon whether there was a "sale" of the patents in question under Section 117(a)(4) of the Internal Revenue Code of 1939, in the light of relevant judicial decisions; for the years 1951 and 1952, the answer depends upon whether taxpayer transferred "all substantial rights" to the patents within the meaning of Section 117(q) of the 1939 Code.

Statute Involved

Internal Revenue Code of 1939:

Sec. 117. Capital Gains and Losses.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) * * *

* * * *

(4) [As amended by Sec. 150(a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital

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[2] Taxpayer James R. Watkins is referred to throughout this brief as "the taxpayer," since taxpayer Lucile L. Watkins is party to this litigation solely by virtue of the fact that she is the wife of James R. Watkins and filed joint returns with him for the tax years in question.

asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * *

(q) [As added by Sec. 1 of the Act of June 29, 1956, c. 464, 70 Stat. 404] *Transfer of Patent Rights.*—

(1) *General rule.*—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

(2) *"Holder" defined.*—For purposes of this subsection, the term "holder" means—

(A) any individual whose efforts created such property, or

(B) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(i) the employer of such creator, nor

(ii) related to such creator (within the meaning of paragraph (3)).

(3) *Exceptions.*—This subsection shall not apply to any transfer described in paragraph (1)—

(A) by a nonresident alien individual, or

(B) between an individual and any related person.

For purposes of this paragraph, the term "related person" means a person, other than a brother or sister (whether of the whole or half blood), with respect to whom a loss resulting from the transfer would be disallowed under section 24(b).

(4) *Applicability.*—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred.

(26 U. S. C. 1952 ed., Sec. 117.)

Statement

The facts material to this appeal, as found by the District Court (R. 16-19), and as they appear from five agreements relating to taxpayer's patents which were Exhibits A through E to taxpayers' complaint,[3] may be summarized as follows:

On April 17, 1934, a patent was issued to taxpayer covering a wood cleated corrugated shipping container.

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[3] The proper construction of these five patent agreements is the crux of the dispute in this litigation, as is evident from the District Court's opinion and taxpayers' brief on appeal. Taxpayers challenge the District Court's summary of the agreements as not "completely accurate" (Br. 3), but they do not print the agreements as part of their record appendix. Instead, they state that (Br. 3): "Three typewritten copies of each agreement will be filed with this brief." We assume that this was done with

Three additional patents for improvements of this container were issued to taxpayer on October 9, 1934, December 27, 1938, and May 13, 1939. In March, 1937, taxpayer entered the employ of Dillman Industries, Inc., and executed an agreement with Dillman giving the corporation a non-exclusive license to manufacture containers under taxpayer's patents. The manufacture and sales of the containers proved successful and early in 1940, after the last two patents in question had been issued, taxpayer began negotiating with some of the officers and leading shareholders of Dillman, who were acting both on behalf of the corporation and of themselves personally, relative to new agreements for the exploitation of the patents. During the negotiations a new corporation, Watkins Patents, Inc., was organized; taxpayer became the owner of 20 per cent of the shares issued and outstanding, and the remaining 80 per cent of the shares were acquired by Dillman or officers and shareholders of that corporation. (R. 16-17.)

On April 17, 1940, taxpayer's four patents were the subject of five agreements entered into simultaneously which may be summarized as follows (R. 17-19; Ex. A, Appendix, *infra;* Exs. B, C, D and E):

1. An agreement between taxpayer and Watkins Patents, Inc. (Ex. A, Appendix, *infra*) whereby taxpayer represented that he was the sole owner of the patents in question and agreed to transfer to the corporation "the

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leave of this Court, and that we may refer to the terms of the agreements, as taxpayers do, although they are not printed. However, for the convenience of the Court, we are printing the principal agreement (Exhibit A) as an appendix to this brief.

Contrary to taxpayers' assertion, we believe that the District Court's summary of the five agreements is thoroughly accurate, so far as it goes. Taxpayers themselves fail to specify any inaccuracies.

non-transferable exclusive license for the use of and sub-licensing under" the patents, together with improvements thereon or extensions thereof, for the life of the patents. (Par. II.) In consideration of this transfer, the corporation agreed to pay taxpayer $3,800 in cash, one-fifth of all the issued capital stock of the corporation, and one-third "of the net royalties collected by it from all products sold under" the patents, subject to minor qualifications. (Par. III.) The corporation agreed to account to taxpayer for the manufacture and sale of the patented container by its licensees, and to "use its best efforts to see that the provisions of all sub-license agreements are faithfully carried out by the respective sub-licensees." (Par. IV.) It was further agreed that if and when taxpayer severed his connection with Dillman Industries, Inc., he should "have a right to establish a business of his own to operate under" the patents; that the corporation should issue a non-exclusive sub-license to taxpayer; that if taxpayer formed a connection with some corporation, individual or co-partnership to operate such a business, and thereafter terminated such connection, the corporation, individual or co-partnership, would have the right, if desired, to "obtain a standard sub-license" from the corporation; and that, thereafter, taxpayer should have the right "to make use of his sub-license * * * either individually or in association with some other individual, co-partnership or corporation which he may thereafter select." All prospective sub-licensees were to be subject to approval by the taxpayer. (Par. VI.) The corporation undertook to defray the expenses of patent litigation up to the amount of $10,000, and it was provided that, upon failure of the corporation to fulfill this obligation, taxpayer should have the right to "cancel this contract * * *." As to litigation expenses in excess of $10,000, taxpayer

could assume them if the corporation did not wish to, and if taxpayer then prosecuted the litigation to a successful conclusion, he was entitled to reimbursement for his expenses from the corporation. (Pars. VII and VIII.) Taxpayer was to be president and a director of the corporation, co-manager of its business, and an employee of the corporation for the purpose of servicing sub-licensees. (Pars. IX and X.) Taxpayer agreed that, upon obtaining "an extension or improvement" of any of the patents in question, he would issue a non-transferable exclusive license therefor to the corporation, provided the corporation reimbursed him for the expenses in obtaining the extension or improvement. Absent such reimbursement, "the right, interest or patent for which payment is refused shall not be included under this contract." (Par. XI.) Finally, taxpayer agreed to provide copies of the agreement and assignments of prior licenses in proper form for filing in the United States Patent Office. (Par. XII.)

2. An agreement (Ex. B) between Watkins Patents, Inc., and Dillman Industries, Inc., whereby Dillman received a nontransferable, non-exclusive sub-license to manufacture and sell the patented container, and agreed in consideration thereof to pay the licensor royalties of one per cent of the net sales of the containers, such royalties to become 1½ per cent in the event taxpayer's employment by Dillman was terminated. Dillman agreed to submit to the licensor a detailed monthly account of its sales. The licensor agreed to assume and conduct at its own expense any patent infringement litigation.

3. An agreement (Ex. C) between taxpayer and Dillman Industries, Inc., whereby the license previously granted to Dillman by taxpayer was cancelled. It was agreed that taxpayer's existing employment contract with

Dillman should be replaced by a new contract (terminable by either party at the end of any year) whereunder taxpayer should receive $400 per month and 25 per cent of Dillman's net income from the sale of products covered by taxpayer's patents. Dillman agreed, upon certain terms and conditions, to sell to taxpayer up to 200 shares of its treasury stock.

4. An agreement (Ex. D) between taxpayer, Dillman Industries, Inc., and Watkins Patents, Inc., which incorporated the agreement constituting Exhibit A, cancelled the previous license given by taxpayer to Dillman, and provided for the issuance of the sub-license from Watkins Patents, Inc., to Dillman which constitutes Exhibit B. The agreement contained certain other provisions, including Dillman's promise to loan Watkins Patents, Inc., certain amounts for the purpose of paying litigation expenses that might arise in defense of taxpayer's patents, in accordance with the terms of Exhibit A. The preamble to this agreement recites that taxpayer is the owner of the patents in question; that he desires "a wider and more general use of, and more extensive manufacture of containers covered by his patents"; that to accomplish this he has proposed to Dillman Industries, Inc., that Dillman "enter into a contract with him for the exclusive handling of his patents by means of licensing various individuals and firms" to manufacture the patented container; and that Dillman, realizing the advantage of such an arrangement, has caused Watkins Patents, Inc., to be organized.

5. An agreement (Ex. E) between taxpayer and Watkins Patents, Inc., whereby the corporation purported to grant taxpayer a nontransferable, nonexclusive sub-license to manufacture and sell the patented container in return

for royalty payments of 1½ per cent of the net sales of such containers. It was agreed that the license was not to be used by taxpayer as long as he was employed by Dillman Industries, Inc., but that upon leaving the employ of Dillman taxpayer should have the right, either independently or in association with other interests, to manufacture and sell under the license. It was further agreed that, if taxpayer entered into such a business association and thereafter terminated it, taxpayer might continue to use his license, either individually or in association with other interests. Any ex-associates of the taxpayer in such a business were to be entitled to a sub-license upon termination of the association. The agreement also contained provisions for monthly accountings by taxpayer to Watkins Patents, Inc., and for the conduct of any patent infringement litigation by the corporation at its own expense.

The District Court found as ultimate facts (R. 19) that the agreement between taxpayer and Watkins Patents, Inc. (Ex. A, Appendix, *infra*), did not effect the transfer from taxpayer to the corporation of all substantial rights to the patents in question, and that the parties did not intend that the agreement should effect such a transfer.

The District Court concluded as a matter of law (R. 20) that the agreement between taxpayer and Watkins Patents, Inc. (Ex. A), did not constitute a sale or assignment of the patents in question, but was only the grant of a license; and that the income reported by taxpayers in their 1949 through 1952 returns and derived from the licensing by taxpayer of Watkins Patents, Inc., was ordinary income and not capital gains.

Summary of Argument

In this case the taxpayer transferred certain patent rights to a corporation in 1940, retaining a royalty interest and certain other rights. The question in this litigation is whether royalties received by the taxpayer from the corporation, in the years 1949 through 1952, constituted ordinary income or capital gains. In statutory terms, the question as to the tax years 1949 and 1950 is whether there was a "sale" of the patents in question under Section 117(a)(4) of the 1939 Code, or merely a license of patent rights. The question as to the tax years 1951 and 1952 is whether there was a transfer of "all substantial rights" to the patent within the meaning of Section 117(q) of the 1939 Code. It is clear that, if the taxpayer failed to transfer "all substantial rights" under Section 117(q), he also failed to effect a "sale" under Section 117(a)(4).

The District Court found as an ultimate fact, taking into account the terms of the instrument transferring patent rights, the terms of related instruments, and the testimony of taxpayer and his witnesses, that the parties neither intended nor effected the transfer of all substantial rights to the taxpayer's patents. This finding in amply warranted by the record. The corporation to which the patent rights were transferred, Watkins Patents, Inc., was created solely for the purpose of sub-licensing taxpayer's patents, with taxpayer retaining the right to veto prospective sub-licensees. The rights to manufacture and sell the patented product were not transferred to the corporation, which received only an "exclusive license for the use of and sub-licensing under" the patents. Moreover, taxpayer retained a so-called sub-license in his own right to manufacture and sell, and the power to confer further sub-licenses without limit on ex-business associates.

Taxpayers concede that the corporation was not intended to manufacture the patented product, but merely to sub-license. Nevertheless, they contend that the phrase, "for the use of," in the granting clause of the instrument transferring the right to sub-license to the corporation, was effective as a matter of law to transfer the rights to manufacture and sell. The authorities they cite do not bear out the proposition that the right to use carries with it, as a matter of law, the rights to manufacture and sell. And in this case it is clear that what was intended and effected by the grant "for the use of," as the District Court held, was simply the right to exploit the patents by sub-licensing.

Taxpayers also rely upon testimony of their witnesses below that the parties intended to transfer ownership of the patents to the corporation. But this testimony is conclusional and self-serving. Insofar as the testimony below bore upon intent to transfer specific rights, powers and obligations, it is fully compatible with the terms of the instrument of assignment, which conveyed only the right to sub-license, the right to share in royalties, and the right to conduct or participate in infringement litigation. The rights to manufacture and sell were not transferred; such rights were obviously substantial; and, in addition, taxpayer retained certain other incidental rights which are cumulatively impressive.

We believe that the other arguments advanced by taxpayers are patently without merit, and that the District Court correctly held the royalties received by the taxpayer to be ordinary income, under a license arrangement, rather than capital gains in the nature of proceeds from the sale of the patents.

ARGUMENT

The royalties received by taxpayer as transferor of patent rights constituted ordinary income, because taxpayer did not transfer all substantial rights to the patents within the meaning of Section 117(q) of the 1939 Code, or sell the patents within the meaning of Section 117(a)(4) of the same Code.

Taxpayer was the inventor and patentee of a shipping container. In 1940 he transferred certain rights under his container patents to Watkins Patents, Inc., retaining a royalty interest and certain other rights. Thereafter, he received substantial royalties from the corporation. He and his wife reported these royalties as ordinary income in the four tax years here involved (1949 through 1952), but now claim a refund for those years on the ground that the royalties should have been reported as long-term capital gain.

Whether royalties received by a transferor of patent rights constitute ordinary income or capital gain is a question which has been much litigated over the years, in a great variety of factual contexts. Until 1950 the relevant statutory criteria were provided by Section 117(a) of the Internal Revenue Code of 1939, *supra*. In statutory terms the question was whether the transfer of patent rights effected the "sale or exchange of a capital asset held for more than 6 months," within the meaning of Section 117(a)(4), the term "capital asset" being defined by Section 117(a)(1). In the case at bar, it is undisputed that the patents in question were capital assets held for more than six months prior to the disputed trans-

fer in 1940, so that the sole question—as to the tax years 1949 and 1950—is whether there was a "sale" of the patents within the meaning of Section 117(a)(4).

The courts have not always agreed as to what constitutes the "sale" of a patent under Section 117(a)(4), as opposed to a mere license. We believe that the law in the Second Circuit is sufficiently spelled out for the purposes of this case in *Cory* v. *Commissioner*, 230 F. 2d 941, certiorari denied, 352 U. S. 828. See also *Bloch* v. *United States*, 200 F. 2d 63 (C. A. 2d), certiorari denied, 345 U. S. 935. In *Cory* the owner of a copyright transferred certain rights thereunder to Scribner's, retaining a royalty interest and certain other rights, including foreign publication rights, movie and dramatic rights, and first serial rights. This Court held that the transfer did not effect a sale, saying (p. 944):

> We do not now decide that a transfer by a citizen of but a part of the bundle [of rights] for a definite sum, or a transfer of the whole for an indeterminate sum, is a sale for purposes of Section 117.[5] We do hold that when, as here, the transfer is both (1) a transfer of a part of the cluster of rights and (2) for an amount wholly indeterminable at the time of the transfer, no such sale occurs.

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[5] The taxpayers cite *Commissioner of Internal Revenue* v. *Hopkinson*, 2 Cir., 126 F. 2d 406 and *TeLinde*, 18 T.C. 91 as authority for their contention that the transfer of a copyright interest for a price to be fixed by the future profits can constitute a sale. In *Hopkinson*, this court held that the transfer of a patent was a sale, despite the fact that the payment turned on future sales. In *TeLinde*, the Tax Court held similarly in dealing with the transfer of a copyright. However, in both cases the taxpayers transferred the entire bundle, so that they no longer retained any interest in them. They had only the right to receive periodic payments of money.

It is evident, we believe, that this broad rationale is as applicable to patents as to copyrights, and requires the conclusion that a patent has not been sold, within the meaning of Section 117(a)(4), where a transferor of patent rights retains *both* a royalty interest *and* "a part of the cluster of rights" inhering in the ownership of a patent. See *Bloch* v. *United States*, *supra*.

As to the tax years 1951 and 1952, the controlling statutory provision is Section 117(q) of the 1939 Code, *supra*, which was added by legislation effective June 29, 1956. Subject to certain limitations, this provision specifically governs the tax treatment of royalties received by transferors of patent rights, and it is retroactive in terms to royalties received in any taxable year beginning after May 31, 1950. Section 117(q)(4). Substantively, it is provided that a transfer of patent rights "shall be considered the sale or exchange of a capital asset held for more than 6 months," despite the retention by the transferor of a royalty interest, if certain requirements are met. One of those requirements is that the transfer must embrace "all substantial rights to a patent." Section 117(q)(1). That is the requirement which is material to this litigation, it being undisputed that the other requirements of the section are met.

Whether "all substantial rights" to a patent have been transferred, within the meaning of Section 117(q)(1), is a test which can best be understood in the light of legislative history. Section 117(q) is substantially the same as Section 1235 of the Internal Revenue Code of 1954, and was enacted in order to make the provisions of Section 1235 retroactive to 1950. S. Rep. No. 1941, 84th Cong., 2d Sess., p. 5 (1956-2 Cum. Bull. 1227, 1229). Thus the legislative history of Section 1235 is pertinent,

and particularly the following passage (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439-440 (3 U. S. C. Cong. & Adm. News (1954) 4621, 5081, 5083)):

> The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments * * *. To illustrate, exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be "sales or exchanges" because, in substantive effect, all "right, title, and interest" in the patent property is transferred (irrespective of the location of legal title or other formalities of language contained in the license agreement). Moreover, the courts have recognized that an exclusive license agreement in some instances may constitute a sale for tax purposes even where the right to "use" the invention has not been conveyed to the licensee, if it is shown that such failure did not represent the retention of a substantial right under the patent by the licensor. It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones. The word "title" is not employed because the retention of bare legal title in a transaction involving an exclusive license

> may not represent the retention of a substantial right in the patent property by the transferor.

In sum, whether "all substantial rights" have been transferred is a question of fact which must be determined upon the peculiar circumstances of each case; and the determination of this question is not controlled by "verbal touchstones," by the retention of bare legal title, or by the retention of patent rights which, in fact, are without substance.

Comparing this requirement of Section 117(q) with the requirements for a "sale" under Section 117(a)(4) in the light of *Cory*, it would appear that the dispositive question is substantially the same under both statutory provisions, so far as the instant case is concerned. In *Cory* this Court held that where only a part of the cluster of rights is transferred, for an amount wholly indeterminable at the time of transfer, no sale occurs. It follows that, where a royalty interest is retained, as in the case at bar, in the absence of a transfer of all of the cluster of rights there cannot be a "sale" under Section 117(a)(4)—a test which is obviously close to the requirement of Section 117(q) that "all substantial rights" be transferred. If anything, the test in *Cory* would seem to be somewhat stricter, since no distinction is there made between substantial and insubstantial rights.

At any rate, there is no need here to consider whether a stricter rule is applicable under Section 117(a)(4) than under Section 117(q), with respect to the quantum of rights which must be transferred.[4] At the least, it is clearly necessary under both provisions that *all sub-*

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[4] The court left open the question whether, even if the entire bundle of rights is transferred, a sale is nonetheless precluded if the consideration consists of royalty payments rather than a definite sum.

stantial rights be transferred, and we submit that the court below correctly contended that this requirement has not been met in the case at bar.

The disputed transfer of patent rights in the instant case was effected by an agreement between the taxpayer and Watkins Patents, Inc., summarized in the statement. (Ex. A, Appendix, *infra.*) This agreement was executed simultaneously with certain other related agreements, also summarized above. (Exs. B, C, D and E.) The District Court properly took the view that the five instruments (R. 22)—

> must all be construed together. What the parties intended by a particular phrase or provision in the agreements must be found from the language itself, its context in the written instrument of which it is a part and the other four agreements, all considered against the background of the surrounding circumstances.

Moreover, the District Court took into account the testimony of taxpayer and his witnesses (R. 20) "relative to the history of the parties to the contracts * * *, the business relationship of the parties and the negotiations before and during the making of the agreements as well as some testimony as to what the parties to the contracts actually did pursuant to them." And in making this broad factual assessment, the court recognized (R. 21) that no particular words of art are necessary, but that the principal agreement (Ex. A) "must in the language it employs in the context of the case convey all substantial rights to the patent, and the language used must be broad enough for this purpose." Pursuant to this assessment, the court found as an ultimate fact that (R. 19):

> The agreement between James R. Watkins and Wat-

> kins Patents, Inc. did not transfer from James R. Watkins to the corporation, nor did the parties intend that it should transfer, all the substantial rights to the patents.

Accordingly, it held (R. 28) that the royalties in question are taxable as ordinary income and not as capital gains.

We submit that the District Court applied the correct criteria; that it made the broadest and least technical analysis possible of all material facts; and that its ultimate finding that taxpayer failed to transfer all substantial rights to his patents is amply warranted by the record, to which we now turn.

The preamble to one of the related agreements here involved contains this illuminating passage (Ex. D, p. 1):

> First Party [taxpayer] is desirous of having a wider and more general use of, and more extensive manufacture of containers covered by his patents, and to accomplish this has approached and proposed to Second Party [Dillman Industries, Inc.] that Second Party enter into a contract with him for the exclusive handling of his patents *by means of licensing various individuals and firms* throughout the United States of America to manufacture crates under the above referred to patents owned by First Party. (Italics supplied.)
>
> Second Party realizes and sees the advantage of such an arrangement and has caused to be organized * * * a corporation, Party of the Third Part under this agreement, known and designated as Watkins Patents, Inc.

The purposes thus stated are confirmed by the testimony of taxpayers' witnesses. Mr. Dillman, a substantial stock-

holder of Dillman Industries, Inc., and also of Watkins Patents, Inc., stated (R. 5) that taxpayer "was anxious to get the box more generally accepted across the country, and the only way that could be done would be to license others to do it." Mr. Dillman also stated (R. 6) that, while taxpayer "wanted to expand the use of the patents * * * he realized to do it would take considerable amount of financing or money, which he didn't have." And further that (R. 9) "we created the new corporation so that it could handle the licensing end of it. We didn't want that involved in Dillman Industries." The same witness testified (R. 10) that Watkins Patents, Inc., was not created to engage in the manufacture of the patented container.

In sum, then, the parties created Watkins Patents, Inc., specifically to handle the sub-licensing of taxpayer's patents. And this limited purpose is clearly reflected and carried out in detail in the principal agreement between taxpayer and Watkins Patents, Inc. (Ex. A.) In paragraph II of this instrument it is provided that taxpayer "does hereby transfer and grant unto said Second Party [Watkins Patents, Inc.] the non-transferable exclusive license for the use of and sublicensing under each and all of the above referred to patents * * *." In paragraph III (c) the corporation "agrees to pay to said First Party [taxpayer] one-third (⅓) of the net royalties collected by it from all products sold under said Letters Patent * * *." And this provision is referred to in the concluding sentence of paragraph III as "the above referred to division of license fees * * *." In paragraph IV the corporation—

> agrees to keep suitable record and account books showing the manufacture and sale of containers by its licensees under this agreement, which record and

> account books shall be open to inspection by said First Party or his duly appointed agent at all reasonable times during business hours. Said Second Party further promises and agrees * * * that it will use its best efforts to see that the provisions of all sublicense agreements are faithfully carried out by the respective sub-licensees.

Paragraph V provides that the corporation is not a guarantor as to payments by other licensees, its only obligation being to exert its best efforts to see that sublicense agreements are faithfully carried out by all sublicensees.

Thus it is abundantly clear that Watkins Patents, Inc., was created solely to serve as a sub-licensing agency, and was endowed with the rights and obligations relevant to that function. It was not intended that the corporation manufacture and sell the patented container—as, indeed, taxpayers concede (pp. 11, 17) in their brief on appeal. Nor did the principal agreement (Ex. A) purport to transfer to the corporation the rights to manufacture and sell. It transferred only the "non-transferable exclusive license for the use of and sublicensing under" the patents in question. Under these circumstances, taxpayers are not helped by their argument (Br. 18) that several years after the agreements in question were executed "the situation might well have changed so that the parties may then have caused Watkins Patents, Inc. to manufacture." We are not concerned in this litigation with any conjectural modifications of the parties' original intention or of their original agreements; no such modifications appear of record; taxpayers must therefore be held to what was intended and done in 1940, when the instruments in question were executed.

It is axiomatic that the rights inhering in a patent include the exclusive rights to manufacture, use, and sell. See, e. g., *Broderick* v. *Neale*, 201 F. 2d 621 (C. A. 10th); *Watson* v. *United States*, 222 F. 2d 689 (C. A. 10th); and *Allen* v. *Werner*, 190 F. 2d 840 (C. A. 5th). Cf. *Waterman* v. *Mackenzie*, 138 U. S. 252. In a given case, one or more of these rights may not be substantial, as recognized by the legislative history pertinent to Section 117(q), quoted above. The example given in that history is of situations where the right to use is of no substance.

In the case of product patents it is obvious that the rights to manufacture and sell are the major rights of value. Here, it was the manufacture and sale of taxpayer's patented container on an expanded scale which the parties hoped to promote. But Watkins Patents, Inc., was neither intended nor empowered to manufacture and sell; it was created only to sub-license those rights. Moreover, the corporation did not have a free hand in determining to whom sub-licenses should be given. Taxpayer reserved to himself the power to veto sub-licensees. (Ex. A, par. VI.)[5] And under other provisions of the principal agreement, as the District Court pointed out (R. 28)—

> Once he had left the employ of Dillman Industries, Inc., which he could do at his own volition after a year, Watkins could associate himself with another to manufacture and sell and that other would gain and retain a license even after Watkins had become disassociated from him; and thereafter Watkins could make a new association with someone else, who would thereby also gain a license and so on without limit.

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[5] Taxpayers' attempt to dismiss this veto power (Br. 23-24) is not convincing in the face of testimony below that discussion between taxpayer and other parties as to the acceptability of prospective licensees (R. 9) "often became quite heated." Taxpayer obviously considered the power as something more than an empty formality.

> At the same time he could veto the granting of licenses by Watkins Patents, Inc. to someone of whom he did not approve. *He possessed power to do more than his transferee could do.* (Italics supplied.)

It is evident, then, that Watkins Patents, Inc., could only sub-license the rights to manufacture and sell; that taxpayer retained an enforceable right to control such sub-licensing through his veto power; and that taxpayer also retained, for himself and any future business associates, free of any control by the corporation, the rights to manufacture and sell. The only realistic conclusion, we submit, is that the exclusive rights to manufacture and sell did not pass to the corporation. Those rights were obviously substantial. Hence the District Court correctly found that taxpayer failed to transfer all substantial rights to the corporation.

In assailing this result, taxpayers argue first that the rights to manufacture and sell were transferred to the corporation, by operation of law, despite the conceded intention of the parties and the provisions of the instruments discussed above. They base this contention on the fact that the granting clause of the principal instrument (Ex. A) contains the words, "for the use of," alleging that (Br. 10) "it is well established by usage of the United States Supreme Court that a transfer of the exclusive use of a patent is a precise expression of an assignment of the right to make, use and sell under the patent." They cite (Br. 9) two Supreme Court decisions in support of this argument, *Hartford-Empire Co.* v. *United States*, 323 U. S. 386, and *Paper Bag Patent Case*, 210 U. S. 405. These cases do not support taxpayers' contention. *Hartford-Empire Co.* was an antitrust case in which the Supreme Court simply observed, in the language quoted by

taxpayers (Br. 9), that a patent owner has the option to use his patent, license it to others, or retain the patent without using it. Similarly, in the *Paper Bag Patent Case*, which was an infringement suit, the Court said that a patentee may exclude others from the use of the patent. In these generalized observations the Court apparently spoke of using a patent in the sense of exercising some or all of the rights thereunder; but such informal, shorthand references certainly do not constitute a holding that a formal instrument which merely conveys the right to *use* is effective, as a matter of law, to convey the rights to manufacture and sell under a patent. Indeed, in *Waterman* v. *Mackenzie*, 138 U. S. 252, which was in infringement suit like *Paper Bag Patent Case*, the Supreme Court held that the several rights to manufacture, use and sell must be conveyed in clear language if the transfer is to effect more than the granting of a mere license.[6]

It is true that the courts, as noted above, do not require any particular words of art for the transfer of the exclusive rights to manufacture, use and sell. But in all cases which we have been able to discover the courts have required the transfer of substantially all the rights in the patent. Thus in *Daily* v. *Universal Oil Products Co.*, 76 F. Supp. 349 (N. D. Ill.), which taxpayer invokes (Br. 9-10), a process patent was involved, and the court held that a grant of (p. 356) "the exclusive *use and control of the process*" was a transfer of all substantial rights. (Italics supplied.) And it reached this conclusion in the factual context of the case, pointing out that (p. 356) "the title of Sunset Oil Refining Company to the patents was constantly advanced and acknowledged by the actions of

[6] Moreover, as this Court observed in the *Bloch* case, *supra* (p. 65) an assignment of a patent in non-tax cases "is not necessarily controlling in the field of taxation."

both parties." Similarly, in *Associated Patentees, Inc.* v. *Commissioner*, 4 T. C. 979, the agreement which taxpayers quote (Br. 10) had been preceded by a formal assignment, whereby all right, title and interest to the patents in question had been formally transferred to the corporation. As for *Reid* v. *Commissioner*, 26 T. C. 622, taxpayers quote (Br. 10) only part of the significant language of the granting clause, under which the taxpayer (p. 628) "hereby grants to the corporation the exclusive and continuing right * * * to utilize her design patents and/or process patents, now existing or hereafter obtained, *in the manufacture and sale of the corporation's products.*" (Italics supplied.) *Pike* v. *United States*, 101 F. Supp. 100 (Conn.), also involved process patents, and the transferee was not only empowered to sub-license but also to utilize the processes in the direct manufacture and sale of goods—in sharp contrast to the situation in the case at bar.

We submit that the District Court was fully warranted in the instant case in holding, as to the phrase "for the use of" in the granting clause of the principal instrument, that it is clear (R. 24) "from its context, the surrounding circumstances and the witnesses' testimony, particularly Mr. Dillman's, that use meant the exploitation of the patents by issuing licenses."

Taxpayers next argue (Br. 12-14) that the District Court erred in rejecting testimony below by taxpayer and his associates that they intended ownership of the patents in question to pass to the corporation. This testimony, however, in addition to being self-serving so far as taxpayer is concerned, is obviously conclusional in nature. The testimony of the lay witnesses in this case is competent only with respect to the transfer of specific

rights, powers and obligations under the patents in question. As so limited, the testimony below is fully compatible with the provisions of the principal agreement which transfer to the corporation only the following rights: (1) the right to sub-license, (2) the right to a share in the royalties collected by the corporation from sub-licensees (thus giving the Dillman interests a return for their investment in Watkins Patents, Inc.), and (3) the right to conduct or participate in infringement litigation (for the protection of the stockholders, principally the Dillman interests). These rights do not add up to ownership, for they do not include the substantial rights retained by the taxpayer which we have discussed above.

Taxpayers next argue (Br. 14-15) that the rights received and obligations assumed by Watkins Patents, Inc., with respect to the conduct of infringement litigation compel the conclusion that an assignment and not a license was intended and effected. This argument is as unsound as its predecessors. It is, of course, well-settled that an assignment of a patent, as distinguished from a license, carries with it *by operation of law* the right to sue for infringement. *Waterman* v. *Mackenzie*, *supra*; *E. W. Bliss Co.* v. *United States*, 253 U. S. 187. It does not follow that the express transfer of the right to sue for infringement is incompatible with a license, or operates to convert into an assignment what would otherwise be a license, no matter how many substantial rights are withheld. At most, the transfer of such a right may shed some light on the intent of the parties, as in *Pike* v. *United States*, *supra*, where it was held that such a transfer, taken together with the other facts of the case, revealed that (101 F. Supp., p. 101) "the operative intent was plainly to pass all the rights the plaintiff had." In the case at bar, in contrast to *Pike*, we have seen that the

exclusive rights to manufacture and sell were not conveyed to the corporation; these rights were obviously substantial; and we submit that no arrangement with respect to infringement litigation can alter the fact that only a license was intended and effected.

Taxpayers argue further (Br. 16-19) that the effect of the District Court's decision is to prevent the assignment of patents to holding companies. This is obviously untrue. When all substantial rights to a patent are transferred, an assignment is accomplished, whether the assignee be a holding company, an operating corporation, or an individual. Taxpayers confuse the property rights of a holding corporation with its functions. Once a corporation has acquired ownership of patents it is immaterial, of course, to what extent the stockholders choose to limit the corporation's direct exercise of the patent rights. But all substantial rights must be transferred in the first instance if the corporation is to be deemed an assignee, as distinguished from a licensee. One of the cases invoked by taxpayers in this connection (Br. 17), *Associated Patentees, Inc.* v. *Commissioner*, *supra*, is illustrative. In that case, as noted above, all right, title and interest in the patents involved were expressly conveyed to the corporation; hence the corporation was a true assignee, regardless of the manner in which it exploited the patents.

Finally, taxpayers contend (Br. 20-26) that certain incidental rights reserved by the taxpayer under his patents were incorrectly regarded by the District Court as indicia of a license. But in analyzing these rights severally, taxpayers are only demonstrating what the District Court itself recognized (R. 26-27), that is, that none of these rights, taken alone, is of such character that its retention will preclude a transfer of patent rights from

constituting an assignment. The District Court viewed these incidental rights cumulatively, in context with the retention of the clearly substantial rights to manufacture and sell, and held (R. 27):

> It is necessary to draw the line somewhere, and it seems plain that Watkins came out of the agreements with such extensive interest that even assuming, *arguendo*, an initial assignment in the granting clause of the contract between him and Watkins Patents, Inc., he finally as a result of the whole transaction, conveyed no more than a license.

CONCLUSION

For all of the reasons set forth above, we submit that the judgment of the District Court is correct and should be affirmed.

Respectfully submitted,

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Assistant Attorney General.

LEE A. JACKSON,
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Attorneys,
Department of Justice,
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SIMON S. COHEN,
United States Attorney

October, 1957.

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APPENDIX

Exhibit A

AGREEMENT BETWEEN
JAMES R. WATKINS, PARTY OF THE FIRST PART
AND
WATKINS PATENTS, INC., PARTY OF THE SECOND PART

THIS AGREEMENT made and entered into this 27th day of April, A. D. 1940 by and between JAMES R. WATKINS, of Niles Center, Illinois, Party of the First Part, and WATKINS PATENTS, INC., a corporation organized under the laws of the State of Illinois and having its principal office at Quincy, Illinois, Party of the Second Part.

WITNESSETH:

WHEREAS, said Party of the First Part is the owner of United States Letters Patent No. 1,955,107 dated April 17, 1934, for Container; United States Letters Patent No. 1,976,693, dated October 9, 1934 for Container; United States Letters Patent No. 2,141,497, dated December 27, 1938 for Container; and United States Letters Patent No. 2,159,642, dated May 23, 1939 for Container;

WHEREAS, said Party of the Second Part is desirous of obtaining a non-transferable exclusive license to each and all of said issued Letters Patent, including each and every part or subdivision thereof and including the inventions covered by each and all of same, together with any and all improvements of the respective patented inventions that may hereafter be issued or authorized, and the sole

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right to issue license for manufacturing and selling containers covered by these patents upon the terms and conditions hereinafter set forth.

Now, THEREFORE, in consideration of the mutual promises and agreements hereinafter set forth of the parties hereto and the sum of One Dollar ($1.00) and other valuable considerations each to the other in hand paid, receipt of which is hereby acknowledged, by each of the parties hereto, the parties hereto have agreed as follows:

I.

Said Party of the First Part represents that the only license agreements now in force in respect of the above patents are the following:

Container Patents, Inc., Chicago, Illinois.
Dillman Industries, Inc., Caruthersville, Missouri.
The Eddy Paper Co., Chicago, Illinois.
Kieckhefer Container Co., Milwaukee, Wisconsin.
The Love Box Company, Wichita, Kansas.
Collins F. Fuller, Chicago, Illinois.

II.

Said Party of the First Part further represents and agrees that he is the sole owner of said Letters Patents and as such owner has the right to issue non-transferable exclusive licenses for the use of and sublicensing under each and all of said United States Letters Patent and the inventions covered by each and all thereof, including each

and every part or subdivision thereof, together with any and all improvements or extensions of the respective patented inventions and said First Party for the consideration hereinafter expressed and the agreements of Second Party herein does hereby transfer and grant unto said Second Party the non-transferable exclusive license for the use of and sublicensing under each and all of the above referred to patents, including each and every part or subdivision thereof, together with the improvements thereon or extensions thereof for the life of said patents and each of same, or any part or parts or subdivisions thereof and for the period or periods of any renewals or extensions thereof, together with all licensing agreements heretofore made under said patents by First Party as hereinabove specifically set forth. All of same to be for the life of said patents and each and every extension and improvement thereon.

III.

In consideration of the grants, promises and agreements of the First Party made herein to Second Party the said Party of the Second Part promises and agrees to pay to said Party of the First Part all of the following:

(a) The sum of Thirty-eight Hundred Dollars ($3800.00) in cash.

(b) Second Party agrees to issue to said First Party as part of the consideration of the aforesaid one-fifth (1/5) of all the issued capital stock of this corporation. (Said one-fifth (1/5) amounting to the sum of 215 shares.) Said stock to be issued as no par stock, fully paid and

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non-assessable, being paid by rights and property received by this corporation.

(c) Said Second Party agrees to pay to said First Party one-third (⅓) of the net royalties collected by it from all products sold under said Letters Patent, including any improvements and extensions thereon, and including one-third (⅓) of all minimum royalties collected by virtue thereof. The amount so received by said First Party in no case shall be less than one percent (1%) of the net factory sales price of all crates manufactured under said First Party's patents or improvements thereon. (The net sale price above referred to shall be the sales price less any deductions made in respect of freight or in respect of cash allowances.)

It is, however, further agreed by and between the parties hereto that the above referred to division of license fees shall be limited to and apply only to license fees received by the party of the Second Part from its administration of said Watkins patents and shall not apply to any license fees or profits said Second Party may receive from any other sources.

IV.

Said Party of the Second Part promises and agrees to keep suitable record and account books showing the manufacture and sale of containers by its licensees under this agreement, which record and account books shall be open to inspection by said First Party or his duly appointed agent at all reasonable times during business hours. Said Second Party further promises and agrees to see that future sub-license agreements made by it shall contain

suitable provisions for the keeping of records and accounts and that it will use its best efforts to see that the provisions of all sub-license agreements are faithfully carried out by the respective sub-licensees.

V.

It is further understood and agreed by and between the parties hereto that the Party of the Second Part is not a guarantor as to payments by other licensees, its only obligation in the premises being to exert its best efforts to see that sub-license agreements are faithfully carried out by all sublicensees, including the payments of all royalties due.

VI.

Second Party recognizes the importance of these patents and inventions to First Party and their possible value to him in establishing a future business connection. Wherefore, it is understood and agreed that if and when said First Party shall hereafter sever his present connection with Dillman Industries, Inc., of Caruthersville, Missouri, he shall then have a right to establish a business of his own to operate under each and all of said letters Patent or to make a connection with any other individual, copartnership or corporation not having been a sub-licensee of Watkins Patents, Inc. under any of said Letters Patent. It is agreed by and between the parties hereto that Second Party shall issue to First Party simultaneously with the signing of this agreement a non-transferable non-exclusive sub-license under each and all of the aforesaid Letters Patents, including each and every part or subdivision

thereof, together with any and all improvements that may be hereafter authorized or issued in form Exhibit 1 hereto attached and made a part hereof as fully to all intents and purposes as if written herein. In case, however, the said Party of the First Part does form a connection with some corporation, individual or co-partnership for the purpose aforesaid and same shall thereafter be terminated upon the termination of same the said individual, corporation or co-partnership shall have the right, if desired, to obtain a standard sub-license from the said Party of the Second Part for the manufacturing of the products theretofore manufactured by First Party and his said associates. It being the intent that the termination of the operating agreement by the First Party and any individual or corporation or co-partnership with which he shall have associated himself shall not deprive the individual, co-partnership or corporation with which he was associated from thereafter continuing their business under a standard sub-license obtained from Second Party for like products. Neither shall the termination of same prevent said Party of the First Part from thereafter continuing to make use of his sub-license, Exhibit 1, either individually or in association with some other individual, co-partnership or corporation which he may thereafter select.

Said Party of the Second Part further agrees to seek sub-licenses immediately and issue sub-licenses to reliable applicants throughout the United States. The sub-licensees to be approved by said First Party. All sub-licenses are to be issued by Second Party for the period of the life of the patent under which same issued as authorized by the exclusive license to Party of the Second

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Part. In case said exclusive license issued to Second Party by First Party reverts to First Party by virtue of the terms hereof, then and in that event the sub-licensees may continue to operate under their sub-license agreement obtained from said Second Party and all license fees and payments thereunder shall after same has reverted to said First Party be paid by such sub-licensees to First Party.

VII.

Second Party further agrees that its net portion of all monies received from sub-licenses shall be held by it in a fund to be used for running expenses of the business and for the purpose of defraying any expense incurred by it in litigation for protection of the aforesaid patents until such fund has accumulated to an amount of Ten Thousand Dollars ($10,000.00) and if at any time said fund shall be less than Ten Thousand Dollars ($10,000.00) it will build up same to said amount by applying all of its portion of the net sums collected by it from sub-licenses until said amount equals Ten Thousand Dollars ($10,000.00) before any monies received from sub-licenses by it shall be distributed to the stockholders.

Said Party of the Second Part in order to obtain and have on deposit an initial sum available for the purpose of defraying any expense in patent litigation incurred by it agrees that it will immediately upon the execution of this agreement obtain a loan from Dillman Industries, Inc. of the sum of Two Thousand Dollars ($2,000.00) and keep said loan on deposit for the purpose of use in defraying and paying any expense incurred by it in patent litigation. It being understood and agreed by and be-

tween the parties hereto that the said Party of the Second Part shall repay said loan out of the first monies collected by it as its portion of net income from license agreements. This provision, however, is subject to prior repayment of sums due First Party under Paragraph VIII, if any.

VIII.

Said Second Party further agrees that should any patent litigation expense be incurred by it before sufficient funds have been accumulated by it either out of the Two Thousand Dollars ($2,000.00) obtained by it on loan as aforesaid, or accumulated out of income from sub-licenses, to defray such patent litigation expense so incurred by it that it will obtain an additional loan from Dillman Industries, Inc. for such additional amount or amounts as is needed by it for that purpose. All loans however, obtained by it from Dillman Industries, Inc. for said purpose shall not in any case exceed a total of Ten Thousand Dollars ($10,000.00) and any and all such loans so obtained by it from said Dillman Industries, Inc. for said purpose of defraying and paying expenses incurred by it in patent litigation shall be repaid by Second Party to said Dillman Industries, Inc. out of its proportion of receipts from sub-licenses thereafter received.

Should the said Party of the Second Part either fail, neglect or refuse to obtain a loan or loans from said Dillman Industries, Inc. amounting in all to the sum of Ten Thousand Dollars ($10,000.00) for the purpose of paying any expenditures incurred by it as needed for patent litigation, as aforesaid, then First Party may at his discretion and upon thirty (30) days notice in writing

to Second Party cancel this contract and in case of cancellation of same the full control and licensings under said patents are to revert to First Party as liquidated damages for breach of this agreement.

It is further stipulated and agreed that in case Second Party exhausts its funds accumulated by it for payment of expenditures incurred by it in patent litigation, as hereinabove provided, together with the additional sum or sums totaling Ten Thousand Dollars ($10,000.00) to be borrowed by it, as herein provided, from Dillman Industries, Inc. and provided further expenditures are necessary to properly continue prosecution or defense under such patent litigation and provided Second Party is unable to or refuses to continue to prosecute or defend further said patent litigation pertaining to aforesaid patents First Party thereupon has the right to take over and continue to prosecute or defend such patent litigation at his own expense, and if said referred to patent litigation under the aforesaid conditions is so carried on by First Party to a conclusion and said conclusion of said litigation sustains the issues in favor of Second Party it is agreed by and between the parties hereto that upon First Party's presenting to Second Party satisfactory evidence of the conclusion of said issues in said patent litigation favorably to Second Party and accompanies same with an itemized correct and signed statement of the expenses so incurred by First Party in the further carrying on of said patent litigation to its final termination, which resulted favorably to Second Party, Second Party will immediately thereupon give to First Party credits on its books for the actual expenses incurred, paid and established by First Party, as aforesaid, and same shall be

repaid to said First Party out of the first net collections received by First Party from sub-licenses thereafter until all such expenditures by First Party have been repaid. Said repayments to said First Party shall be made by said Second Party out of the aforesaid income received by it before any repayments are made therefrom to Dillman Industries, Inc. for loans theretofore made by it to Second Party.

It is agreed, however, that when the expenses so incurred and established by First Party, as aforesaid, are repaid to it then and thereafter all its portion of net sums collected by the said Party of the Second Part from sublicenses shall be paid to said Dillman Industries, Inc. until the loans obtained by Second Party from said Dillman Industries, Inc. are repaid in full and after the repayment of First Party of the amount expended by it, as aforesaid, and the repayment to Dillman Industries, Inc. of the loans obtained from it by Second Party, as aforesaid, all its portion of net collections from sublicensees thereafter received by Second Party shall be held by it and accumulated until a new fund of Ten Thousand Dollars ($10,000.00) is accumulated for the purpose of defraying and paying the expenses of business and any future patent litigation before any dividends or distributions shall be made to the shareholders of said corporation.

It is further understood and agreed that in consideration of said First Party paying the expenses of patent litigation, as aforesaid, after the Party of the Second Part has refused or is unable to carry same on, as aforesaid, then Second Party agrees with First Party that it will issue or cause to be issued to First Party a sufficient number

of shares of its capital stock of this corporation, which, together with the number of shares theretofore issued to him or upon his request or direction, shall together equal twenty-five percent (25%) of the total number of shares of capital stock issued and outstanding of this corporation at that time. All loans by Dillman Industries, Inc. to Watkins Patents, Inc. shall bear interest at a rate not exceeding Five Percent (5%) per annum.

IX.

It is further agreed by and on the part of the Party of the Second Part that it is a corporation incorporated under the laws of the State of Illinois; that it has an authorized outstanding capital of 1200 shares of no par value; that it has issued and outstanding or will immediately issue 1075 shares of capital stock of no par value, four-fifths (4/5) of which said stock so issued is issued for a paid in capital in cash of Five Dollars ($5.00) per share, and one-fifth (1/5) of said capital stock so issued is issued for property and rights of the value of Five Dollars ($5.00) per share; that this corporation is managed and controlled by an authorized Board of five Directors; that its officers consist of a President, a Vice-President, a Secretary and Treasurer and Assistant Secretary; that its Board of Directors elected for the first year of its organization are James R. Watkins, A. W. D. Weis, Kennett W. Dillman, James T. Ahern and Henry B. Weis; that its officers elected for the first year are James R. Watkins, President and Manager, A. W. D. Weis, Vice-President, Kennett W. Dillman, Secretary and Treasurer, and James T. Ahern, Assistant Secretary, Henry B. Weis,

Director. All of said officers and directors are shareholders. That the By-laws of this corporation provide that James R. Watkins and Kennett W. Dillman are designated and authorized by the Board of Directors as co-managers of this corporation. The By-Laws of this corporation also provide that the salary of each officer and director shall be One Dollar ($1.00) per year.

X.

It is further agreed by and between the parties hereto that it will be necessary for said Second Party to have available a competent party who can and will service licenses under sub-licenses granted by said Second Party pursuant to this agreement, and that the said Party of the First Part is competent and qualified for said work.

It is further agreed that said First Party is now employed by Dillman Industries, Inc. and said First Party by and with the consent of said Dillman Industries, Inc. has agreed and does agree to service all licensees of said Second Party for a charge of Fifteen Dollars ($15.00) per day plus traveling expenses incurred in the carrying on of said services, which said sum the Party of the Second Part agrees to collect from such licensees for such services actually rendered and said Second Party agrees to pay said sum so collected to Dillman Industries, Inc. Such amount so paid being to reimburse said Dillman Industries, Inc. for the time of said First Party and for his expenses paid by said Dillman Industries, Inc.

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XI.

Said Party of the First Part further represents and agrees that he will immediately hereafter upon the obtaining of an extension or improvement on any of the foregoing patents in this agreement referred to or immediately upon the obtaining of any new Letters Patent or his interests or rights in other patents on containers composed principally of fibre (more particularly known as corrugated paper and fibre board) and wood, or covering special construction and application of fibre board and wood, issue a non-transferable exclusive license for the use of and sub-licensing under each and all of said improvements or extensions of the aforesaid patents and under each and all of said new United States Letters Patents, or his interests or rights in other patents as above set forth, and the inventions covered thereby, including each and every part or subdivision thereof for the period or periods of any such renewals or extensions or any such new patents, all of same to be for the life of such extensions or improvements or such new patents. And it is understood and agreed that the Party of the Second Part is by this agreement authorized and empowered to make use of any and all improvements and extensions on the above and foregoing patents obtained by First Party and any and all new inventions obtained by him, and any and all interests or rights in other patents acquired by him, as aforesaid, and may authorize sub-licensees to use same prior and after the issuance by First Party to Second Party of new non-exclusive licenses, as herein provided, and said First Party shall not authorize any other person, individual, co-partner, or corpora-

tion to make use of in any way any such improvement or extension or new patent herein referred to.

It is understood and agreed that the said Party of the First Part will upon the obtaining of any improvement or extension on the above and foregoing patents in this agreement set forth or upon the obtaining of any new patent, or upon his obtaining any interest or rights in other patents, as herein referred to, submit to said Party of the Second Part a true and correct itemized account of his expenses actually incurred in the obtaining of same and each of same and said Party of the Second Part will thereupon repay to said First Party any and all such expenses. If Watkins Patents, Inc. should consider the expense or cost of any of the aforesaid greater than it desires to pay for same it may refuse to pay same, in which case the right, interest or patent for which payment is refused shall not be included under this contract.

XII.

It is further agreed by and on the part of the said Party of the First Part that contemporaneously with the signing of this agreement or thereafter upon request he will sign, execute and deliver to said Party of the Second Part another and additional exclusive non-transferable license agreement covering all of said Letters Patents hereinabove specified and set forth in accordance with the provisions of this agreement and will also make another and additional assignment to said Second Party of all licenses heretofore issued by him under said Letters Patents and will deliver all of same to the Party of the Second Part. Said additional assignments and agreements to be in proper form for properly filing in the United States

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Patent Office at Washington, D. C. and if said additional assignments and agreements are made as requested and shall not be in form as required by the United States Patent Office, or any department connected therewith, then and in that event the said Party of the First Part will upon request immediately sign, execute and deliver such assignment or assignments and agreements in form as required and requested by said Second Party in order to comply with the requirements of the United States Patent Office.

IN WITNESS WHEREOF, said Party of the First Part has hereunto set his hand and seal, and the said Party of the Second Part has caused these presents to be subscribed by its duly authorized Vice-President and attested by its Secretary and its corporate seal hereunto affixed, all done by virtue of authority duly given by the Board of Directors said Party of the Second Part. Four originals of this contract are signed and executed. All done the day and year first above written.

/s/ JAMES R. WATKINS (SEAL)
Party of the First Part.

WATKINS PATENTS, INC.
Party of the Second Part.

by /s/ A. W. D. WEIS
its Vice-President

SEAL

ATTEST:

/s/ K. W. DILLMAN
its Secretary

SUPREME COURT, U.S.
Office - Supreme Court, U.S.
FILED
MAY 24 1958
JOHN T. FEY, Clerk

Supreme Court of the United States

OCTOBER TERM, 1957

No. 1019

JAMES R. WATKINS and LUCILE L. WATKINS,

Petitioners,

—v.—

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

JOHN H. WEIR
CURTISS K. THOMPSON
Attorneys for Petitioners
205 Church Street
New Haven, Connecticut

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Supreme Court of the United States

OCTOBER TERM, 1957

No. .....

JAMES R. WATKINS and LUCILE L. WATKINS,

Petitioners.

—v.—

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable Chief Justice of the United States and Associate Justices of the Supreme Court of the United States:

Your petitioners, James R. Watkins and Lucile L. Watkins, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on February 26, 1958 in the above entitled action.

Opinions Below

The Opinion of the Court of Appeals is reported in 252 F. 2d 722 *infra* Appendix A and the Opinion* of the United States District Court for the District of Connecticut is reported in 149 F. Supp. 718.

* Since nine additional copies of the record as printed for use in the Court of Appeals have been filed pursuant to Rule 21(4), neither Exhibit A nor the opinion of the District Court is appended to this petition.

Jurisdiction

The date of the judgment to be reviewed is February 26, 1958 *infra* Appendix B. Jurisdiction of the Court is invoked under Section 1254 of Title 28 of the United States Code (Act of June 25, 1948, c. 646, 62 Stat. 928).

The jurisdiction of the District Court was invoked under Section 1346 of Title 28 of the United States Code, as amended.

Statutes Involved

The statute involved with respect to the years 1949 and 1950 is Section 117 (a)(4) of the Internal Revenue Code of 1939 which provides:

> "Sec. 117. (a) Definitions.—As used in this chapter—
>
> * * * * *
>
> (4) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;"

The statute involved with respect to the years 1951 and 1952 is Section 117 (q) of the Internal Revenue Code of 1939, as added by Section 1 of the Act of June 29, 1956, c. 464, 70 Stat. 404, which provides:

> "(q) Transfer of Patent Rights.—
>
> (1) General Rule.—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange

of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminus with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

(2) 'Holder' Defined.—For purposes of this subsection, the term 'holder' means—

(A) any individual whose efforts created such property, or

(B) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(i) the employer of such creator, nor

(ii) related to such creator (within the meaning of paragraph (3)).

(3) Exceptions.—This subsection shall not apply to any transfer described in paragraph (1)—

(A) by a nonresident alien individual, or

(B) between an individual and any related person. For purposes of this paragraph, the term 'related person' means a person, other than a brother or sister (whether of the whole or half blood), with respect to whom a loss resulting from the transfer would be disallowed under section 24 (b).

(4) Applicability.—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred."

Section 1235 of the Internal Revenue Code of 1954 is substantially identical with Section 117 (q) of the Internal Revenue Code of 1939.

Statement of the Matter Involved

In this action petitioners seek to recover alleged overpayments of income taxes for the years 1949, 1950, 1951 and 1952. The ultimate question is whether royalties received by petitioner[1] under the provisions of Exhibit A constituted ordinary income as claimed by the respondent and as held by the courts below or capital gain as claimed by petitioner. The respondent conceded that the patents in this case were long-term capital assets. For the years 1949 and 1950 the determining issue is whether Exhibit A effected a "sale" of patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939; for the years 1951 and 1952 the determining issue is whether Exhibit A transferred "property consisting of all substantial rights" to patents within the meaning of Section 117 (q) of the Internal Revenue Code of 1939.

The essential facts are stated briefly in the District Court's Finding of Facts.

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[1] Throughout this petition James R. Watkins is referred to as "the petitioner" since Lucile L. Watkins is party to this litigation solely by virtue of the fact that she is the wife of James R. Watkins and filed joint returns with him for the tax years in question.

"1. On April 17, 1934 there was issued to the plaintiff, James R. Watkins, U. S. Letters Patent No. 1,955,107 covering a wood cleated corrugated shipping container.

2. Subsequently, additional Letters Patent were issued to him for improvements on the shipping container as follows:

> October 9, 1934, Letters Patent No. 1,976,693; December 27, 1938, Letters Patent No. 2,141,497; and May 13, 1939, Letters Patent No. 2,159,642.

3. In March 1937 the plaintiff, James R. Watkins, entered the employ of Dillman Industries, Inc. of Caruthersville, Missouri, manufacturers of lumber, wooden boxes and crates, and at that time entered into an agreement with Dillman Industries, Inc. whereby Watkins granted to the corporation a non-exclusive license to manufacture containers under the patents which, up to that time, had been issued to him.

4. The manufacturing and sales of the shipping containers proved to be successful and early in 1940, after the last two patents relating to the shipping container had been issued to Watkins, negotiations went on between James R. Watkins and some of the officers and leading shareholders of Dillman Industries, Inc. acting both on behalf of the corporation and themselves personally, relative to new agreements for the exploitation of the patents.

5. During said period a new corporation, Watkins Patents, Inc., was organized under the laws of the State of Illinois in which the plaintiff, James R. Watkins, owned twenty per cent of the shares issued and outstanding and the remaining eighty per cent of said shares were owned by Dillman Industries, Inc. or officers and shareholders of Dillman Industries, Inc.

6. On April 17, 1940 the four patents above referred to were the subject of five agreements entered into, eodem instante, which may generally be summarized as follows (We have inserted the Exhibit letter at the beginning of each summary):

(a) Exhibit A.—An agreement between James R. Watkins and Watkins Patents, Inc. by which Watkins transferred to Watkins Patents, Inc. a non-transferable exclusive license for the use of and sublicensing under the patents. By the same agreement Watkins Patents, Inc. agreed to pay Watkins $3,600 in cash and twenty per cent of the stock in Watkins Patents, Inc. and one-third of the net royalties derived from licensed manufacture under the patents, subject to certain minor qualifications. Said contract provided further that Watkins had a non-transferable, non-exclusive sublicense under the patents, and that anyone with whom he became associated to practice his sublicense had a right to sublicense from Watkins Patents, Inc. even after the termination of the association between Watkins and such individual, copartnership or corporation. Said agreement further provided that in the event of litigation concerning said patents, or any of them, Watkins Patents, Inc. had a duty to defray the cost of such litigation up to the amount of $10,000 and that with regard to expenditures above said amount Watkins Patents, Inc. had the option of paying the additional amount necessary or to refuse to do so, in which event said James R. Watkins had the right to carry on such litigation at his own expense with certain provisions for reimbursement in the event of his successful prosecution or defense of said litigation. Said contract further provided that sublicenses of Watkins Patents, Inc. were sub-

ject to the approval of James R. Watkins and that all existing licenses were transferred to Watkins Patents, Inc. by James R. Watkins. The contract also provided that Watkins Patents, Inc. had a duty to account to Watkins and that copies of the contract and assignments of prior licenses should be in proper form for filing in the U. S. Patent Office.

(b) Exhibit B.—An agreement between Watkins Patents, Inc. and Dillman Industries, Inc. by which Dillman Industries received a non-transferable, non-exclusive license to manufacture and sell containers under the patents of Watkins Patents, Inc. in return for its payment to Watkins Patents, Inc. of royalties of one per cent of the net sales of containers sold under the license, such royalties to become one and one-half per cent in case the employment of James R. Watkins by Dillman Industries, Inc. was terminated.

(c) Exhibit C.—An agreement between Dillman Industries, Inc. and James R. Watkins by which a license previously granted to Dillman Industries, Inc. by Watkins was canceled. This agreement provided further that Watkins' employment contract with Dillman Industries, Inc. was terminated and a new employment contract entered into, under the terms of which Dillman Industries, Inc. was to pay Watkins $400 per month and twenty-five per cent of Dillman Industries' net income from the manufacture and sale of products under Watkins Patents. At the end of any year either party could terminate the employment contract by giving notice. The agreement also contained certain provisions concerning the holding by Watkins of stock in Dillman Industries, Inc.

(d) Exhibit D.—An agreement between James R. Watkins, Dillman Industries, Inc. and Watkins Patents, Inc. which incorporated agreement (a) above, canceled a previous license given by Watkins to Dillman Industries, Inc. and provided for the execution of a sublicense to Dillman Industries, Inc. from Watkins Patents, Inc. (agreement (b) above). The agreement contained certain other provisions, including Dillman Industries' promise to loan Watkins Patents, Inc. certain amounts for the purpose of paying litigation expenses that might arise in defense of Watkins' patents.

(e) Exhibit E.—An agreement between Watkins Patents, Inc. and James R. Watkins by which Watkins Patents, Inc. purported to grant James R. Watkins a non-transferable, non-exclusive license to manufacture and sell containers under the Watkins Patents in return for royalty payments of one and one-half per cent of the net sales of such containers. The agreement further provided that said license was not to be used by James R. Watkins as long as he was employed by Dillman Industries, Inc.; but that upon leaving the employment of Dillman Industries, Inc. (which at his option he might do at the end of any year), he might operate under the license, or if he became associated with any individual, co-partnership or corporation, such enterprise might manufacture and sell under his license. The agreement provided that upon termination of Watkins' association with any such individual, co-partnership or corporation, such individual, co-partnership or corporation would have the right to obtain a license from Watkins Patents, Inc. The agreement expressly provided that Watkins, upon

termination of such associations, might continue to use his license individually or enter into subsequent associations, one at a time, with other individuals, co-partnerships or corporations, which could use his license during the period of association and obtain a license from Watkins Patents, Inc. upon termination of the association."

The District Court held that the royalties received by the petitioner for all four years were ordinary income to him and not capital gain. The Court of Appeals affirmed.

Questions Presented

1. Is a transfer of patent rights prevented from being a "sale" of the patent rights within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, because the agreement of transfer contains provisions which (1) prohibit further transfer, (2) require approval of licensees by the transferor and (3) are conditions subsequent?

2. Does a non-transferable exclusive license for the use of and sublicensing under specified patents for the life of the patents constitute a "sale" of said patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, or does it constitute simply a "license to license" because the parties intended that the transferee use the patents by granting licenses thereunder to others to manufacture and sell the invention in return for royalty pay-

ments and not by itself manufacturing, selling or using the invention?

3. Does a transfer of the exclusive right to license others under specified patents, of the right to prosecute and defend infringement actions and of the rights of the transferor in outstanding licenses constitute a "sale" within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights" to the patents within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended?

Reasons for Granting the Writ

In holding that the transfer of patent rights is prevented from being a "sale" within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, because the agreement of transfer contains provisions which (1) prohibit further transfer, (2) require approval of licensees by the transferor and (3) are conditions subsequent, the Court of Appeals (a) decided an important question of federal law which has not been, but should be, settled by this Court, and (b) decided this question in a way which is in conflict with applicable decisions of this Court and with decisions of other Courts of Appeal.

The ultimate issue in this case is whether income to the petitioner for the transfer of patent rights is ordinary income or capital gain, a question which Judge Murrah began his majority opinion in *Dairy Queen of Oklahoma, Inc.* v. *Commissioner* (C. A. 10, 1957), 250 F. 2d 503, 504, by characterizing as "the familiar, yet still perplexing, question."

In the instant case the Court of Appeals held that the income was ordinary income because no sale or transfer of all substantial rights resulted due to the following rights "remaining in or bestowed upon" the petitioner: "(1) a right to royalties; (2) the power of termination in event of failure of the transferee to obtain necessary loans to conduct patent litigation; (3) Watkins' limited right to conduct patent litigation; (4) the restraint of non-transferability on the grant; (5) the fact that through the grant Watkins became a substantial shareholder in the transferee; (6) the reservation to Watkins of the license to manufacture and sell and to sublicense at reduced royalties and with a limited right of transferability; (7) Watkins' right to approve all sublicensees of the transferee."

The presence of these provisions in the agreements is conceded. The question is not one of construction of the agreements, but of legal effect of these provisions. Similar provisions are usual in agreements of this kind. They are designed to require "proper effort to promote the manufacture and sale of the patented article." *Allen* v. *Werner* (C. A. 5, 1951), 190 F. 2d 840, 842; *Carroll Pressure Roller Corp.* v. *Commissioner* (1957), 28 T. C. No. 152; app. dism'd on stip. (C. A. 9); *Commissioner* v. *Celanese Corp.* (C. A., D. of C., 1944), 140 F. 2d 339, 342; *Kronner* v. *United States* (Ct. Cls., 1953), 110 F. Supp. 730, 734; *United States* v. *Carruthers* (C. A. 9, 1955), 219 F. 2d 21, 25.

Under the Internal Revenue Code of 1939, this issue was decided by the courts, at least until 1956, on the basis of whether the transfer constituted an assignment or a license. That the document of transfer was termed an "exclusive license" did not prevent it from being an assignment. *Myers* v. *Commissioner* (1946), 6 T. C. 258, was typical of many decisions holding an "exclusive license" to be an assignment, notwithstanding installment payment of royalties and reservation of conditions subsequent. The Commis-

sioner of Internal Revenue first acquiesced in that decision (1946-1 C. B. 3), but in *Mimeo 6490*, 1950-1 C. B. 9, he withdrew that acquiescence and announced that for the taxable years beginning after June 1, 1950, he would regard royalties paid under such assignments or exclusive licenses as taxable as ordinary income, if payment were measured by the production, sale or use of the property transferred or if it were payable periodically over a period generally coterminous with the use of the patent. In the Internal Revenue Code of 1954, Congress included Section 1235 dealing with the sale or exchange of patents. The purpose of this section was stated to be "to obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the Nation * * * " Senate Report No. 1622, 83d Cong., 2nd Sess., pp. 438-441 (3 U. S. C. Cong. & Adm. News (1954) 5084, 5083). In 1956, in order to make the provisions of Section 1235 retroactive to taxable years beginning after May 31, 1950, Congress enacted Section 117 (q) as an amendment to the Internal Revenue Code of 1939. Senate Report No. 1941, 84th Cong. 2nd Sess., p. 5 (1956-2 Cum. Bull. 1227, 1229). Thus, the legislative history of Section 1235 is pertinent, particularly the explanation of the section contained in Senate Report No. 1622 at page 439:

> "The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. * * * It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been

> released to the transferee, rather than recognizing less relevant verbal touchstones. The word 'title' is not employed, because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor. Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., a forfeiture on account of non-performance) are not to be considered as such a retention as will defeat the applicability of this section. On the other hand, a transfer terminable at will by the transferor would not qualify."

Congress has thus clearly stated the type of retained rights which "are not to be considered as such a retention as will defeat the applicability of this section." They must be "not of the nature of rights evidenced by the patent" and "not inconsistent with the passage of ownership." A "reservation in the nature of a condition subsequent" is not inconsistent with the passage of ownership.

This Court has consistently held that all that a patentee obtains by a patent is "the right to exclude everyone from making, using or vending the thing patented, without the permission of the patentee." *Bloomer* v. *McQuewan* (1852), 14 How. 539, 549. Only the very limited right of petitioner to conduct patent litigation after failure of Watkins Patents, Inc. to do so is of that nature. That right, however, is clearly not inconsistent with the passage of ownership since it is, like (2) and (6), in the nature of a condition subsequent. We therefore submit that the decision of the

Court of Appeals in the instant case is contrary to the Congressional intent in enacting Section 117 (q).

Many other courts have been called upon to consider the effect of rights similar to those present in this case. We do not find any other case in which the court has counted the number of so-called rights, as did the District Court and the Court of Appeals in this case, but all have examined the rights to determine their nature and effect. Almost without exception, the courts have held that the rights involved in the instant case are not inconsistent with the passage of ownership. A brief consideration of each of these rights may be helpful:

(1) Right to royalties—this provision does not reserve to petitioner "any control over the patent or its use" nor does it "limit or qualify the scope of the grant." *Watson* v. *United States* (C. A. 10, 1955), 222 F. 2d 689, 691. Contra *Bloch* v. *United States* (C. A. 2, 1952), 200 F. 2d 63; cert. den. 345 U. S. 935.

(2) Power to terminate—this provision is a condition subsequent. *Lawrence* v. *United States* (C. A. 5, 1957), 242 F. 2d 542, 545.

(3) Petitioner's right to conduct litigation if transferee failed to do so—this provision is analogous to a covenant to defend title. *Commissioner* v. *Celanese Corp.* (C. A., D. of C., 1944), *supra*, 342. It does not reserve "any property or proprietary right in the invention which was at variance with an assignment. * * * " *Watson* v. *United States* (C. A. 10, 1955), *supra*, 692.

(4) Restraint of non-transferability—this provision is intended to "protect the rights of the parties under the contract, not to proscribe, limit or qualify their intent and purpose * * * " *Watson* v. *United States* (C. A. 10, 1955), *supra*, 691.

(5) Petitioner became shareholder in transferee corporation—this is not the ownership of an interest in the patents. Cf. *Graham* v. *Commissioner* (1956), 26 T. C. 730; *Crook* v. *United States* (D. C., W. D. Penn., 1955), 135 F. Supp. 242, 252. Cf. also Section 117 (q)(3), Section 24 (b)(1)(B) of the Internal Revenue Code of 1939, and Senate Report No. 1622, p. 441, which deny capital gain treatment to sales to a corporation in which the seller owns fifty per cent of the stock. The ownership in this case is only twenty per cent.

(6) Sublicense to petitioner if he left employ of Dillman Industries, with limited right to transfer—this provision is a condition subsequent. *Watson* v. *United States* (C. A. 10, 1955), *supra*, 691.

(7) Approval of sublicenses—this provision "does not interfere with the full use of the patent by the assignee." *Rollman* v. *Commissioner* (C. A. 4, 1957), 244 F. 2d 634, 639. Cf. *Dreymann* v. *Commissioner* (1948), 11 T. C. 153, 161; Non-acq. 1950-2 C. B. 5.

Practically all of the decided cases on this point have a grouping of these rights. In the vast majority of the decisions it has been held that a sale resulted, notwithstanding the retention of these rights. We submit that the decisions in the following cases constitute the prevailing view in the courts, both before and after the application of Section 117 (q), and that the decision in the instant case is in conflict with the decisions in these cases:

Watson v. *United States* (C. A. 10, 1955), *supra*;
Dairy Queen of Oklahoma, Inc. v. *Commissioner* (C. A. 10, 1957), *supra*;
Rollman v. *Commissioner* (C. A. 4, 1957), *supra*;
Lawrence v. *United States* (C. A. 5, 1957), *supra*;
Kavanagh v. *Evans* (C. A. 6, 1951), 188 F. 2d 234;

Commissioner v. *Celanese Corp.* (C. A., D. of C., 1944), *supra;*

Kronner v. *United States* (Ct. Cls., 1953), *supra;*

Golconda Corp. v. *Commissioner* (1957), 29 T. C. No. 57;

Carroll Pressure Roller Corp. v. *Commissioner* (1957), *supra;*

Crook v. *United States* (D. C. W. D. Penn., 1955), *supra;*

First National Bank of Princeton v. *United States* (D. C. N. J., 1955), 136 F. Supp. 818; app. dism'd (C. A. 3).

The decision in the instant case extends the holding of the same court in *Bloch* v. *United States* (C. A. 2, 1952), *supra*, to Section 117 cases. In the *Bloch* case the Court of Appeals, at page 66, admitted that its decision was contrary to those in *Allen* v. *Werner* (C. A. 5, 1951), *supra, Commissioner* v. *Celanese Corp.* (C. A., D. of C., 1944), *supra* and decisions of the Tax Court in *Kimble Glass Co.* v. *Commissioner* (1947), 9 T. C. 183 and the *Myers* case.

Until the questions at issue in these cases and in the instant case are settled by this Court great uncertainty will exist and inventors cannot have the incentive to contribute to the welfare of the Nation which Congress sought to give them by the enactment of Section 1235 of the Internal Revenue Code of 1954 and of Section 117 (q) of the Internal Revenue Code of 1939, as amended in 1956. Different results by the various courts ruling on substantially identical contract provisions are clearly not conducive to such encouragement.

II

In affirming the District Court's decision that a non-transferable exclusive license for the use of and sublicensing under specified patents for the life of the patents did not constitute a "sale" of said patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, but rather did constitute simply a "license to license" because of the fact that the parties intended that the transferee use the patents by issuing licenses thereunder to others to manufacture and sell the invention and not by itself manufacturing, selling or using the invention, the Court of Appeals decided an important question of federal law which has not been, but should be, settled by this Court.

The District Court said that "under certain circumstances and in certain contexts" the language used in the granting clause of Exhibit A could be construed to convey all substantial rights to a patent. That language is, "does hereby transfer and grant * * * the non-transferable exclusive license for the use of and sublicensing under each and all * * * the patents." Decisions construing the words "use of the patent" or similar wording to constitute a sale of patent rights are: *Reid* v. *Commissioner* (1956), 26 T. C. 622; Acq. 1956-2 C. B. 8; *Associated Patentees, Inc.* v. *Commissioner* (1945), 4 T. C. 979; Acq. 1946-1 C. B. 1; *United States* v. *Borton* (D. C., N. J., 1950), 1950 1 U. S. T. C. 9276; *Pike* v. *United States* (D. C., Conn., 1951), 101 F. Supp. 100; *Daily* v. *Universal Oil Products Co.* (D. C., Ill., 1947), 76 F. Supp. 349, 356; *Graber* v. *United States* (D. C., Ore., 1958), 158 F. Supp. 510. This Court has frequently employed the term "use of the patent" as meaning "make, use and sell under the patent." For instance, in *Continental Paper Bag Co.* v.

Eastern Paper Bag Co. (1908), 210 U. S. 405, at page 425, this Court said:

> " * * * It shows that whenever this court has had occasion to speak it has decided that an inventor receives from a patent the right to exclude others from its use for the time prescribed in the statute * * *
>
> "And, in *Bloomer* v. *McQuewan*, 14 How. 539, 549, Chief Justice Taney said: 'The franchise which the patent grants consists altogether in the right to exclude everyone from making, using or vending the thing patented, without the permission of the patentee. This is all that he obtains by the patent.' "

It seems clear that "the right to exclude others from its use" in the first sentence is synonymous with "the right to exclude everyone from making, using or vending the thing patented" in the second.

It is a fact also that Section 117 (q)(1)(A) employs the term "transferee's use of the patent" as synonymous with "purchaser's use of the patent."

Other provisions of Exhibit A are clearly indicative of an intention to effect an assignment and not a license. The provision granting the transferee the right to conduct infringement litigation is one, since a licensee has no right to sue infringers. *E. W. Bliss Co.* v. *United States* (1920), 253 U. S. 187, 192; *Littlefield* v. *Perry* (1874), 21 Wall. 205, 223. In *Pike* v. *United States, supra* the Court regarded this right as very significant.

The provision of Exhibit A expressly transferring all existing licenses to the transferee is a further indication of an intent to pass full ownership to the transferee. *Hook* v. *Hook & Ackerman, Inc.* (C. A. 3, 1951), 187 F. 2d 52, 58. The provisions of Exhibit A that copies of the contract and assignments of prior licenses should be in proper form for

filing in the U. S. Patent Office is also an indication, since these are common provisions in assignments. *Ellis, Patent Assignments* (3rd ed.), Sections 334, 336.

The surrender by Dillman Industries, Inc. of the license issued to it by petitioner and the issuance of a new license (Exhibit B) from Watkins Patents, Inc. to it is still further indication of where the parties intended ownership to rest, as is the issuance by Watkins Patents, Inc. to petitioner of a license (Exhibit E). The issuance of these two licenses by Watkins Patents, Inc. is a practical construction of Exhibit A by the parties and is conclusive evidence that the parties contemplated that all proprietary rights would be transferred to Watkins Patents, Inc. by Exhibit A. Exhibit E is also clear evidence that petitioner intended to give up all right to manufacture and sell since he felt that he needed a license from Watkins Patents, Inc. to do so if he should ever leave Dillman Industries. Cf. *Cutter Laboratories* v. *Lyophile-Cryochem Corp.* (C. A. 9, 1949), 179 F. 2d 80, 93. If Exhibit A transferred only the power to license, Exhibit E was entirely unnecessary and Exhibit B should have run from petitioner to Dillman Industries, Inc. as did the prior license. In fact, if Exhibit A was not an assignment but only a license, Watkins Patents, Inc. received no right to issue licenses in its own name but should have issued those licenses in petitioner's name, which was not done.

The District Court held, however, that Exhibit A could not constitute an assignment or transfer of all substantial rights to a patent because the parties did not intend Watkins Patents, Inc. to manufacture and sell under the patents but to issue licenses to others. The decision was based on *Six-Wheel Corporation* v. *Sterling Motor Truck Co.* (C. A. 9, 1931), 50 F. 2d 568. In the opinion of Judge Wyzanski, stated in *Standard Oil Co.* v. *Markham* (D. C., S. D. N. Y. 1945), 64 F. Supp. 656, 662; aff'd and mod. (C. A. 2) 163 F.

2d 917; cert. den. 333 U. S. 873; that decision "is so plainly at variance with the weight of authority that it should be discredited * * * "

We respectfully submit that the effect of the decision in the instant case is that a patent holding company cannot be organized to be the owner of a patent. In view of the thousands of such companies which now exist, this decision is of far-reaching importance. The Hartford-Empire Company was an outstanding example—it was purely a patent holding company engaged in licensing others. *Hartford-Empire Co.* v. *United States* (1945), 323 U. S. 386. In *Associated Patentees, Inc.* v. *Commissioner* (T. C. 1950), *supra,* and *United States* v. *Borton* (D. C. N. J., 1950), *supra,* both the Tax Court and the District Court held that Associate Patentees, Inc. was the owner of patents by assignment although it engaged solely in the business of licensing others. Similarly, in *Massey* v. *United States* (C. A. 7, 1955), 226 F. 2d 724, the finding discloses that the assignee was not a manufacturer.

In *Hartford-Empire Co.* v. *United States, supra,* this Court said, at page 432, that a patent owner "has no obligation either to use it or to grant its use to others" and, at page 417, that patent owners have always enjoyed the option either to "set the price for its use by others, elect to use it himself and refuse to license it, or to retain it and neither use nor license it." By the express words of Exhibit A the transferee in the instant case received the exclusive license to use the patent and to sublicense thereunder. The decision on this point, that because Watkins Patents, Inc. did not use the patents but did license them, it could not be the owner of the patents, is contrary to the position taken by this Court.

III

In affirming the District Court's decision that a transfer of the exclusive right to license others under specified patents, of the right to prosecute and defend infringement actions, and of the rights of the transferor in outstanding licenses does not constitute a "sale" of those patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights" to the patents within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, the Court of Appeals decided an important question of federal law which has not been, but should be, settled by this Court.

Section 154 of Title 35 of the United States Code governs the rights contained in the grant of a patent:

> "Every patent shall contain a short title of the invention and a grant to the patentee, his heirs or assigns, for the term of seventeen years, of the right to exclude others from making, using or selling the invention throughout the United States, referring to the specification for the particulars thereof. A copy of the specification and drawings shall be annexed to the patent and be a part thereof."

The "right to exclude others" is given to "the patentee, his heirs or assigns"; it seems clear that only the "owner" can have this right. See *Bauer* v. *O'Donnell* (1913), 229 U. S. 1, 10; *Ethyl Gasoline Corp.* v. *United States* (1940), 309 U. S. 436, 456. This right to exclude others is "the essence of the patent privilege." *Transwrap Corp.* v. *Stokes Co.* (1947), 329 U. S. 637, 643. It is also the essence of property ownership. *Rohmer* v. *Commissioner* (C. A. 2, 1946), 153 F. 2d 61, 63, note 9; cert. den. 328 U. S. 862. In the identical type of case the Court said, in *Dairy Queen of*

Oklahoma, Inc. v. *Commissioner* (C. A. 10, 1957), *supra*, at page 506:

> "Of course if the conditions and restrictions upon the exercise of the granted right were such as to reserve in the grantor the proprietary right in the franchise, the grant would be something less than a sale and probably a mere license. But the traditional test of ownership is the power to exclude others. Taxation is not concerned with refinements of title, but with actual command of the property. See *Corliss* v. *Bowers*, 281 U. S. 376, 50 S. Ct. 336, 74 L. Ed. 916; *Griffiths* v. *Helvering, Commissioner*, 308 U. S. 355, 60 S. Ct. 277, 84 L. Ed. 319."

The right to sue for patent infringement "is considered as the primary indicia of true ownership of a patent." *Young* v. *Commissioner* (1958), 29 T. C. No. 92. Since he does not possess the right to exclude others, it follows that a licensee cannot license others to use the patent. In *Ellis, Patent Assignments*, Sec. 55, the author states:

> " * * * The broad fundamental practical difference between an assignment and a license is that the former gives the transferee the right to sue for infringement and the latter gives the transferee immunity from suit for infringement. The first gives positive rights, the second negative rights."

The decision in the instant case is contrary (1) to the express wording of the statute in that it holds that a transfer of the right to exclude others does not constitute an assignment but only a license, although the statute gives that right only to the patentee, his heirs or assigns, and (2) to the many decisions which give effect to the ownership denoted by the right to exclude others. Certainly, if the

right to exclude others is the essence of the patent privilege, the patentee's complete transfer of that right should be held to be a transfer of all substantial rights to the patent.

Here again the decision of the Court of Appeals is contrary to the legislative intent. *Senate Report No. 1622*, page 439, *supra* states:

> " * * * The section does not apply to a property right in an invention differing from the monopoly rights evidenced by a patent. * * * "

The report also states the sole requirement "that all substantial rights evidenced by the patent" must be transferred. The substantial rights evidenced by the patents and the monopoly rights evidenced by the patents, being simply the right to exclude others from use of the patents, were transferred in the instant case. The legislative intent requires that this transfer be held to be a "transfer of property consisting of all substantial rights" to these patents.

CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX A

Opinion of Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 108—October Term, 1957.

(Argued November 15, 1957 Decided February 26, 1958.)

Docket No. 24663

JAMES R. WATKINS and LUCILE L. WATKINS,

Appellants,

—v.—

UNITED STATES OF AMERICA,

Appellee.

Before:

CLARK, *Chief Judge,*

MOORE, *Circuit Judge* and LEIBELL, *District Judge.*

Appeal from United States District Court for the District of Connecticut; Robert P. Anderson, *Judge.*

James R. Watkins and Lucile L. Watkins appeal from the dismissal on the merits, 149 F. Supp. 718, of their action against the United States of America for refund of income taxes paid by them for the years 1949 through 1952 on royalty payments received under a patent licensing agreement.

Affirmed.

JOHN H. WEIR, Esq., New Haven, Conn. (Curtiss K. Thompson, Esq., New Haven, Conn., on the brief), *for plaintiffs-appellants, James R. Watkins and Lucile L. Watkins.*

JOHN N. STULL, Esq., Department of Justice, Washington, D. C. (Charles K. Rice, Assistant Attorney General, Lee A. Jackson, Harry Baum, Grant W. Wiprud, Attorneys, Department of Justice, Washington, D. C., Simon S. Cohen, United States Attorney for the District of Connecticut, on the brief), *for appellee, United States of America.*

MOORE, *Circuit Judge*:

The primary question on this appeal is whether royalty payments received by an inventor, James R. Watkins, and his wife (the taxpayers), during the years 1949 through 1952 from an assignment of the patents should have been treated as capital gains derived from a sale of assets held more than six months (*i.e.* payments on account of the purchase price of the patents) or were merely ordinary income received under a licensing agreement. The district court held that the payments were properly taxed at income tax rates and denied the plaintiffs' claim for a refund.

The applicable sections of the Internal Revenue Code of 1939 are section 117(a)(4), which governs the royalty payments received in the years 1949 and 1950, and section 117(q) (as added by amendment June 29, 1956, 70 Stat. 404), which governs those payments received in the years 1951 and 1952. Section 117(a)(4) defines "long-term capital gain" as the "gain from the exchange or sale of a capital asset held for more than 6 months." Section 117(q) relates specifically to the transfer of patent rights and states that

as a "*General Rule.*—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are— (A) payable periodically over a period generally coterminous with the transferee's use of the patent, or (B) contingent on the productivity, use, or disposition of the property transferred."

As the Senate noted in its report on section 1235 of the Internal Revenue Code of 1954, which is substantially the same as section 117(q) of the 1939 Code, the test in determining for income tax purposes whether a patent has been sold is a realistic one. "[T]he entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones." Sen. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439-40. Accordingly, to answer the question whether the transfer of the patents from Watkins to Watkins Patents, Inc. was an assignment or a license, it is necessary to examine in some detail the transaction alleged to have been an assignment as well as other facts relating thereto.

In 1937 the taxpayer, Watkins, became an employee of Dillman Industries, Inc., which was engaged in the manufacturing and marketing of wooden boxes and crates. At that time Watkins was the holder of two patents covering wood cleated corrugated shipping containers and had granted to Dillman Industries, Inc. a non-exclusive license to manufacture and sell containers covered by the patents. In addition to Dillman Industries, Inc. licenses had also been granted by Watkins to five other Midwestern firms.

During 1938 and 1939 Watkins obtained two additional patents for improvements on the invention.

The manufacture and sale of the containers proved to be successful and in 1940 Watkins and the management of Dillman Industries, Inc., desirous of obtaining wider acceptance of patented products, determined that the best way of obtaining such acceptance was through extensive licensing to other firms in the industry. To this end they organized in 1940 a new corporation, Watkins Patents, Inc., the function of which was to grant limited territorial licenses to manufacture and sell the patented products.

To carry out the plan, five agreements, dated April 27, 1940, were entered into simultaneously, consisting of: (1) an agreement between Watkins and Watkins Patents, Inc. (Exh. A); (2) an agreement between Watkins Patents, Inc. and Dillman Industries, Inc. (Exh. B); (3) an agreement between Watkins and Dillman Industries, Inc. (Exh. C); (4) an agreement between Watkins, Dillman Industries, Inc. and Watkins Patents, Inc. (Exh. D); and (5) an agreement between Watkins and Watkins Patents, Inc. (Exh. E).

By the agreement (Exh. A) Watkins transferred and granted to Watkins Patents, Inc. "the non-transferable exclusive license for the use of and sublicensing under each and all of the above referred to patents, * * * together with all licensing agreements heretofore made under said patents by first party [Watkins] as hereinabove specifically set forth." In return therefor Watkins received $3,800 in cash, one-fifth of the stock of Watkins Patents, Inc. (the other 80% being held by Dillman Industries, Inc. or members of its management) and one-third of the net royalties Watkins Patents, Inc. received from the patented products sold, or an amount equal to 1% of the net sales price of all patented products sold, whichever was greater. In addition to the cash, stock and royalty payments (the tax treatment of which is in issue here), Watkins Patents, Inc.

further agreed to give Watkins a non-transferable, non-exclusive license to manufacture and sell at a reduced royalty rate of 1½% of the net sales price. Watkins, however, could not use this license so long as he remained an employee of Dillman Industries, Inc. Although the license was described as non-transferable, any company, not a licensee of Watkins Patents, Inc., with which Watkins should become connected, could operate under the license and in the event that he severed his connection with such company it would still retain the right to operate under the license at the reduced royalty rate. Watkins could also continue to bestow upon any other company with which he might become associated in the future the same licensing rights. In addition Watkins retained the right to approve all sub-licensees of Watkins Patents, Inc. Not only did this veto right give him considerable power over the operations of the corporation but it tended to defeat the purported exclusiveness of the corporation's power to sublicense.

Under the agreement between Watkins Patents, Inc. and Dillman Industries, Inc. (Exh. B) a non-transferable, non-exclusive license was given by Watkins Patents, Inc. to Dillman Industries, Inc. to manufacture and sell the patented products at a reduced royalty of 1% of net sales, to be increased to 1½% if Watkins left the employ of Dillman Industries, Inc. The agreement between Watkins and Dillman Industries, Inc. (Exh. C) provide for the cancellation of the original license from Watkins and for Watkins' employment under a new employment contract with Dillman Industries, Inc. The three-party agreement (Exh. D) between Watkins, Watkins Patents, Inc. and Dillman Industries, Inc. provided for the acceptance by Dillman Industries, Inc. of the provisions of the grant from Watkins to Watkins Patents, Inc. contained in the agreement (Exh. A) and the fifth agreement (Exh. E) gave back to Watkins a sublicense from Watkins Patents, Inc. as defined in the first agreement between them (Exh. A).

Appellants argue that the grant of a "license for the use of and sublicensing under each and all of the above referred to patents" conveyed to Watkins Patents, Inc. the right to manufacture and sell the patented products. They, therefore, conclude that appellants thereby divested themselves, in effect, of their interests in the patents. It is unnecessary, however, to pass upon that issue because, even assuming that Watkins Patents, Inc. received these rights, as a result of the five agreements which must be considered together, Watkins emerged from the transaction possessed of so many rights and interests both present and future that much less than a complete transfer was achieved by the transaction.

Among the rights remaining in or bestowed upon Watkins by the various agreements were: (1) a right to royalties; (2) the power of termination in event of failure of the transferee to obtain necessary loans to conduct patent litigation; (3) Watkins' limited right to conduct patent litigation; (4) the restraint of non-transferability on the grant; (5) the fact that through the grant Watkins became a substantial shareholder in the transferee; (6) the reservation to Watkins of the license to manufacture and sell and to sublicense at reduced royalties and with a limited right of transferability; (7) Watkins' right to approve all sublicensees of the transferee.

The district court recognized that it would have been possible for Watkins to have retained some legal interests in the patents without reducing the purported assignment or sale to a license (see the citation of various situations discussed by the courts and set forth in the trial court's opinion, 149 F. Supp. 718, 724). Appellants argue that each of these retained interests was merely incidental to, and not in itself inconsistent with, the passage of ownership, and that the entire aggregate of such interests did not add up to the reservation of substantial rights.

Summarizing the more important features of the retained rights, Watkins Patents, Inc. could not transfer its power to sublicense; Watkins at any time after one year could transfer a valuable and irrevocable sublicense to any firm which he desired to join; Watkins had a veto power over the sublicensees of Watkins Patents, Inc.; and Watkins possessed the conditional right to take over and control patent litigation. By virtue of his stock interest in Watkins Patents, Inc. and his veto power, Watkins also could have had a considerable voice in the affairs of that company.

As the district court clearly pointed out, in no case where an assignment was found did such a mass of interests remain in the transferor. It may well be that Watkins desired to divest himself of many of his rights for tax purposes but at the same time retain as many as possible. In so doing, however, he must accept the risk that the transfer might not meet the standard of releasing "substantially all rights of the owner in the patented property." The very multiplicity of agreements simultaneously executed is significant. Had Watkins desired to divest himself irrevocably of substantially all rights in his patents such a transfer could have been accomplished in a single agreement in simple language conveying such rights.

The conclusion of the trial court "that the plaintiffs have failed to establish that James R. Watkins and those contracting with him either intended or accomplished a sale or assignment of the patents to Watkins Patents, Inc. and the payments in question must be treated as ordinary income and not as capital gains" is clearly justified by an accurate analysis of the agreements evidencing the transaction.

The judgment is affirmed.

APPENDIX B

Judgment

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court house in the City of New York, on the 26th day of February one thousand nine hundred and fifty-eight.

Present:

HON. CHARLES E. CLARK,
Chief Judge.

HON. LEONARD P. MOORE,
Circuit Judge.

HON. VINCENT L. LEIBELL,
District Judge.

JAMES R. WATKINS and LUCILE L. WATKINS,
Plaintiffs-Appellants,

—v.—

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court for the District of Connecticut.

This cause came on to be heard on the transcript of record from the United States District Court for the District of Connecticut, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

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JUN 19

No. 1019

In the Supreme Court of the United States

OCTOBER TERM, 1957

JAMES R. WATKINS AND LUCILE L. WATKINS,
Petitioners

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE UNITED STATES IN OPPOSITION

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---

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 16-28)[1] is reported at 149 F. Supp. 718. The opinion of the Court of Appeals (Pet. App. 26-31) is reported at 252 F. 2d 722.

---

[1] Record references herein are to the appendix to the taxpayers' brief in the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals was entered on February 26, 1958. (Pet. App. 32-33) Taxpayers' petition for a writ of certiorari was filed on May 23, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in ruling, on the facts presented, that a transfer of patent rights by the taxpayer[2] constituted a license, not a "sale" of the patents under Section 117(a)(4) of the Internal Revenue Code of 1939 nor a transfer of "all substantial rights" in the patents under Section 117(q) of the same Code, so that royalties received by the taxpayer from the licensee were taxable as ordinary income rather than as capital gain.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) * * *

* * * *

(4) [As amended by sec. 150(a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Long-term capital gain.*—The term "long-term capital gain"

[2] Taxpayer James R. Watkins is referred to throughout this brief as "the taxpayer," since taxpayer Lucile L. Watkins is a party to this litigation solely by virtue of the fact that she is the wife of James R. Watkins and filed joint returns with him for the tax years in question.

means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * *

(q) [As added by Sec. 1 of the Act of June 29, 1956, c. 464, 70 Stat. 404] *Transfer of Patent Rights.*—

(1) *General rule.*—A transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

(2) *"Holder" defined.*—For purposes of this subsection, the term "holder" means—

(A) any individual whose efforts created such property, or

(B) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(i) the employer of such creator, nor

(ii) related to such creator (within the meaning of paragraph (3)).

(3) *Exceptions.*—This subsection shall not apply to any transfer described in paragraph (1)—

(A) by a nonresident alien individual, or

(B) between an individual and any related person.

For purposes of this paragraph, the term "related person" means a person, other than a brother or sister (whether of the whole or half blood), with respect to whom a loss resulting from the transfer would be disallowed under section 24(b).

(4) *Applicability.*—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred.

(26 U.S.C., 1952 ed., and Supp. IV Appendix, Sec. 117.)

STATEMENT

The material facts, as found by the District Court (R. 16-19) and as set forth by the Court of Appeals (Pet. 27-29), may be summarized as follows:

On April 17 and October 9, 1934, patents were issued to taxpayer covering a wood cleated corrugated shipping container. In March, 1937, taxpayer entered the employ of Dillman Industries, Inc., a manufacturer of shipping containers, and executed an agreement with Dillman giving the corporation a nonexclusive license to manufacture and sell the containers covered by his patents. Licenses had also been granted by taxpayer to five other midwestern firms. The manufacture and sale of the containers proved successful and in 1940, after two more improvement patents had been issued to taxpayer, he and the management of Dillman deter-

mined that the best way of obtaining wider acceptance of the patented container was through extensive licensing to other firms in the industry. To this end, they organized in 1940 a new corporation, Watkins Patents, Inc., the function of which was to grant limited territorial licenses to manufacture and sell the container. Taxpayer received 20 per cent of the stock and the remaining 80 per cent was acquired by Dillman, its officers and shareholders. (R. 16-17; Pet. 27-28.)

To carry out the plan, five agreements dated April 27, 1940, were executed simultaneously, consisting of agreements severally between taxpayer and Watkins Patents, Inc. (Ex. A), between Watkins Patents, Inc., and Dillman Industries, Inc. (Ex. B), between taxpayer and Dillman (Ex. C), between taxpayer, Dillman, and Watkins Patents, Inc. (Ex. D), and between taxpayer and Watkins Patents, Inc. (Ex. E). Under the primary agreement (Ex. A), taxpayer transferred to Watkins Patents, Inc. "the non-transferable exclusive license for the use of and sublicensing under each and all of the above referred to patents, * * * together with all licensing agreements heretofore made under said patents" by taxpayer. In consideration of this transfer, the corporation agreed to issue to taxpayer 20 per cent of its stock and to pay him $3,800 in cash plus one-third of the net royalties the corporation received from the patented products sold, or an amount equal to 1 per cent of the net sales price of all patented products sold, whichever was greater. In addition, the corporation further agreed to give taxpayer a nonexclusive license to manufacture and sell at a reduced royalty rate of 1½ per cent of the net sales price. Taxpayer could use this license only after leaving the employ of Dillman; but he could then use it in association

with any company, whether or not a licensee of Watkins Patents, Inc., and in the event that he severed his connection with such company it would still retain the right to operate under the license at the reduced royalty rate. Taxpayer could also continue to bestow upon any other company with which he might become associated in the future the same licensing rights. The agreement further provided that in the event of litigation involving the patents the corporation had a duty to defray the costs of litigation up to the amount of $10,000, with the option of paying or refusing to pay additional amounts. If the corporation refused to pay additional amounts, taxpayer had the right to carry on the litigation at his own expense with certain provisions for reimbursement in the event of his successful prosecution or defense of the litigation. The agreement further provided that sublicenses to be issued by the corporation were subject to the approval of the taxpayer. (R. 17-18; Pet. 28-29.)

Under the agreement between Watkins Patents, Inc., and Dillman (Ex. B), a non-transferable, nonexclusive license was given Dillman to manufacture and sell at a reduced royalty of 1 per cent of net sales, to be increased to 1½ per cent if taxpayer left the employ of Dillman. The agreement between taxpayer and Dillman (Ex. C) canceled the original license from taxpayer to Dillman and provided a new employment contract between Dillman and taxpayer, which either party could terminate at the end of a year. The three-party agreement (Ex. D) provided for Dillman's acceptance of the transfer of patent rights by taxpayer to Watkins Patents, Inc., and contained certain other provisions, including Dillman's promise to loan Watkins Patents, Inc., certain amounts for the purpose of

paying litigation expenses that might arise in defense of taxpayer's patents. The fifth agreement (Ex. E) gave back to taxpayer a sublicense from Watkins Patents, Inc., under the terms of the first agreement between them (Ex. A). (R. 18-19; Pet. 29.)

The District Court found as ultimate facts that the primary agreement between taxpayer and Watkins Patents, Inc. (Ex. A) did not effect the transfer from taxpayer to the corporation of all substantial rights in the patents involved, and that the parties did not intend that the agreement should effect such a transfer. (R. 19.) It accordingly concluded that the agreement did not constitute a sale or assignment of the patents in question, but only the grant of a license; and that, therefore, the income reported by taxpayers in their 1949-1952 returns, derived from the licensing of the patents, was ordinary income and not capital gain. (R. 20.) The Court of Appeals agreed and affirmed the judgment. (Pet. 31.)

ARGUMENT

1. The ultimate question presented is whether royalties received by a transferor of patent rights constituted ordinary income or capital gain. This is a question which has been much litigated over the years, in a great variety of factual contexts. As to royalties received by taxpayer in the tax years 1949 and 1950, the answer depends on whether the transfer effected a "sale or exchange" of patents, within the meaning of Section 117(a)(4), *supra*, pp. 2-3. As to the royalties received in the tax years 1951 and 1952, the answer depends on whether there was a transfer of "all substantial rights" to the patents within the meaning of Section 117(q), *supra*, pp. 3-4. This latter provision,

added to the 1939 Code in 1956, is substantially the same as Section 1235 of the 1954 Code, and was enacted in order to make the provisions of that section retroactive to 1950. S. Rep. No. 1941, 84th Cong., 2d Sess., p. 5 (1956-2 Cum. Bull. 1227, 1229). Thus the legislative history of Section 1235 is pertinent in determining what constitutes "all substantial rights" to a patent under Section 117(q). Of particular relevance is the following passage in the committee report (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439-440 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5082-5083)):

> The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments * * *. * * * It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones.

In keeping with Congress' view of the test under "existing law"—*i.e.*, that the entire transaction should be "examined in its factual context"—it has been repeatedly held that whether a given transfer of patent rights constitutes a "sale" under Section 117(a)(4) or a transfer of "all substantial rights" under Section

117(q) depends upon all the facts and circumstances of the particular case. The decisions, including those relied upon by taxpayer, have taken into account the conduct of the parties, the language of the instruments, and other circumstances surrounding the transfer, with a view to making a realistic assessment of the substantiality of the rights, if any, retained by the transferor. See, *e.g.*, *Rollman* v. *Commissioner*, 274 F. 2d 634 (C.A. 4th); *Lawrence* v. *United States*, 242 F. 2d 542 (C.A. 5th); *Switzer* v. *Commissioner*, 226 F. 2d 329 (C.A. 6th); *United States* v. *Carruthers*, 219 F. 2d 21 (C.A. 9th). Cf. *E. W. Bliss Co.* v. *United States*, 253 U.S. 187, 192; *Cory* v. *Commissioner*, 230 F. 2d 941 (C.A. 2d), certiorari denied, 352 U.S. 828. Whatever the language employed, it is clear that the courts have looked to the individual facts in order to apply the "realistic test" adopted by Congress, and have concluded that a patent "sale" occurred only when satisfied that the transferor divested himself of all substantial rights in his patent.

In the case at bar, the District Court found (R. 19) that taxpayer did not transfer all substantial rights in his patents to Watkins Patents, Inc. Its detailed factual assessment in support of this finding (R. 22-26, 28) shows that it construed the five agreements involved in the context of the testimony of taxpayer and his witnesses (R. 20) "relative to the history of the parties to the contracts * * *, the business relationship of the parties and the negotiations before and during the making of the agreements as well as some testimony as to what the parties to the contracts actually did pursuant to them." It concluded that Watkins Patents, Inc., was created only for the purpose of

carrying out the single function of sublicensing;[3] and that while taxpayer (R. 26) "transferred with his right hand a bundle of legal interests which he claims constituted complete ownership, he took back with his left hand a substantial number of those interests." And, among other retained interests discussed in detail (R. 25-26), the court emphasized the following (R. 28):

> Once he had left the employ of Dillman Industries, Inc., which he could do at his own volition after a year, Watkins could associate himself with another to manufacture and sell and that other would gain and retain a license even after Watkins had become disassociated from him; and thereafter Watkins could make a new association with someone else, who would thereby also gain a license and so on without limit. At the same time he could veto the granting of licenses by Watkins Patents, Inc. to someone of whom he did not approve. He possessed power to do more than his transferee could do.

In affirming, the Court of Appeals properly held (Pet. 30-31) that the record clearly justified the finding of the lower court that taxpayer failed to transfer to Watkins Patents, Inc., all substantial rights in his patents. In the words of the court below (Pet. 30), tax-

[3] While taxpayers have never disputed that Watkins Patents, Inc., was created with the intent that it serve only as a sublicensing agency, they renew here (Pet. 17-20) their argument below that the primary agreement (Ex. A) was effective as a matter of law to transfer to the corporation the powers to manufacture, use and sell. We believe that the District Court properly rejected this argument for the reasons given in its opinion. (R. 23-25.) However, the Court of Appeals refrained from passing on the question (Pet. 30), noting only (R. 28) the undisputed fact that the sole *intended* function of Watkins Patents, Inc., was to sublicense.

payer "emerged from the transaction possessed of so many rights and interests both present and future that much less than a complete transfer was achieved by the transaction."

2. Contrary to taxpayers' assertion (Pet. 10-16), there is no conflict with the decisions of other courts. The most that can be said of the many cases invoked by taxpayers is that in one or more isolated factual aspects they bore a similarity to the case at bar, *i.e.*, the transferors there involved qualified their transfers of patent rights in ways similar to *some* of the qualifications attaching to the transfer in the case at bar. This the District Court recognized. (R. 26-27.) But, viewed in entirety, not one of the cases cited by taxpayers provides anything like a close parallel to the case at bar—nor do taxpayers attempt to demonstrate such a parallel. Among numerous differences between the factual complex presented here and that presented in other cases, this case is significantly unique in the concurrent presence of three factors: (1) taxpayer's transferee, Watkins Patents, Inc., was not created to manufacture and sell the patented product, but for the sole purpose of sublicensing; (2) taxpayer could veto sublicenses by the corporation at will; (3) after one year, and again, at will, taxpayer could manufacture and sell and, in effect, license others to manufacture and sell. Thus, as the District Court pointed out (R. 28), taxpayer "possessed power to do more than his transferee could do."

These concurrent factors serve to distinguish this case from *Watson* v. *United States*, 222 F. 2d 689 (C.A. 10th), and like cases with which taxpayer claims conflict. (Pet. 15-16). In those cases, the qualifications attached to the transfer were simply conditions subse-

quent beyond the control or volition of the transferor; moreover, they were conditions which did not diminish the immediate grant of exclusive rights to the transferee, but rather were designed to promote the manufacturing and selling operations of the transferee. See *Allen* v. *Werner*, 190 F. 2d 840, 842 (C.A. 5th).

In the case at bar, by contrast, the power of veto and prospective power of sublicensing retained by the taxpayer could not operate to implement and promote the full and exclusive exercise by Watkins Patents, Inc., of the rights inhering in the patents to manufacture and sell the patented container, because the corporation was created only to function as a sublicensing agency. And it is obvious that the retained powers robbed even the corporation's sublicensing powers of any exclusivity. Moreover, the exercise of the retained powers depended solely upon taxpayer's volition, rather than upon any independent event of failure of the transferee to perform its obligations. These retained rights are not conditions subsequent of the kind involved in *Watson* and *Werner*, and it was only conditions subsequent of the latter kind which Congress had in mind when it said (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 440 (3 U.S.C. Cong. & Adm. News (1954) 4621, 5083)):

> Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., *a forfeiture on account of non-performance*) are not to be considered as such a retention as will defeat the applicability of this section. *On the*

other hand, a transfer terminable at will by the transferor would not qualify. [Italics supplied.]

Here, the taxpayer retained a power of veto and a prospective power of sublicensing which were not dependent upon such a condition subsequent as "a forfeiture on account of nonperformance." Since taxpayer retained full power to render the corporation's sublicensing power nonexclusive and, indeed, to stultify it altogether by veto, the transactions were akin to "a transfer terminable at will by the transferor [which] would not qualify."

CONCLUSION

The petition for a writ of certiorari should be denied.

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